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Watching the Watchers: Preventing I.R.S. Abuse of the Tax System,

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WATCHING THE WATCHERS: PREVENTING I.R.S. ABUSE OF THE TAX SYSTEM

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ABSTRACT

As a result of broad outcries against the incompetence and aggressiveness of the I.R.S., Congress reined in its behavior, requiring it to focus on treating taxpayers as customers. Congress also created oversight bodies to ensure that the I.R.S. would comply with the new mandate. Though those oversight bodies face some difficulties — most notably, the unwillingness of Congress to adequately fund them — they nonetheless have proven effective at checking the I.R.S.'s misbehavior with regard to taxpayers.

Congress has not, however, been as solicitous to the tax law itself. The I.R.S. can act in ways that violate both the letter and the intent of the tax law. Where such violations either provide benefits to select groups of taxpayers without directly harming others, or where the harm to taxpayers is de minimis, nobody has the ability or incentive to challenge the I.R.S. and require it to enforce the tax law as written.

Congress could control the I.R.S.'s abuse of the tax law. Using insights from the literature of administrative oversight, this Article proposes that Congress provide standing on third parties to challenge I.R.S. actions. If properly designed and implemented, such "fire-alarm oversight" would permit oversight at a significantly lower cost than creating another oversight board. At the same time, it would be more effective at finding and responding to I.R.S. abuse of the tax system and would generally preserve the I.R.S.'s administrative discretion in deciding how to enforce the tax law.

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I. INTRODUCTION

Taxpayers dislike and distrust tax collectors. These feelings transcend time and culture. In ancient Egypt, for example, the government leased tax collection to the highest bidder; the tax collector had to remit a set amount to the government, irrespective of its collections. To prevent abuse, the government required these tax collectors to provide receipts to taxpayers.[1] The authors of the New Testament categorized tax collectors alongside extortioners, adulterers, and the unjust.[2] A thousand years later, Byzantine peasants fled the "merciless tax collector."[3] In eighteenth-century Wales, tax men attempting to collect the excise tax on spirits found

1. William Harms, *Chicago Demotic Dictionary Refines Knowledge of Influential Language*, UCHICAGONEWS, Sept. 17, 2012, http://news.uchicago.edu/article/2012/09/17/chicago-demotic-dictionary-refines-knowledge-influential-language.

2. William O. Walker, Jr., *Jesus and the Tax Collectors*, 97 J. BIBLICAL LITERATURE 221, 229 (1978).

3. Charles M. Brand, *Two Byzantine Treatises on Taxation*, 25 TRADITION 35, 38 (1969).

themselves attacked, horsewhipped, robbed, killed, and disfigured.[4] And, in the United States in the nineteenth century, tax collectors earned the public's disdain through incompetence and corruption.[5]

Modern tax regimes have not overcome this dislike and distrust. In contemporary Tanzania, taxpayers hide in the bush to evade tax collectors and, when tax collectors use more coercive means to collect taxes, taxpayers reciprocate by, among other things, attacking tax collectors and burning their offices.[6] Anecdotal evidence suggests that tax collectors broadly accept bribes in Taiwan, India, Nepal, and Thailand.[7]

The dislike and distrust of tax collectors in the modern era extends beyond the taxpayers of developing economies. The American public, for example, generally dislikes the I.R.S.[8] For a select few, this dislike leaves the world of the reasonable and extends itself into the hyperbolical.[9] But dislike and distrust of the I.R.S. is not the exclusive realm of the conspiracy theorist and the tax protestor. Taxpayers remain aware that President Nixon attempted to use the I.R.S. to harass his political enemies.[10] And they remain aware that, should they be unlucky enough to catch the I.R.S.'s notice, it could bring its full administrative powers to bear against them.

In September of 1997, the Senate Judiciary Committee heard three days of testimony about the unchecked abuses of taxpayers at the hands of the I.R.S.[11] A retired priest testified that the I.R.S. wrongly assessed $18,000 in taxes from his mother's estate.[12] A California woman testified that $7,000 in back taxes ballooned to $16,000 while the I.R.S. sent notices only to her

4. THOMAS P. SLAUGHTER, THE WHISKEY REBELLION 13 (1986).

5. HARRY EDWIN SMITH, THE UNITED STATES FEDERAL INTERNAL TAX HISTORY FROM 1861 TO 1871 282 (1914).

6. Odd-Helge Fjeldstad, *Taxation, Coercion and Donors: Local Government Tax Enforcement in Tanzania*, 39 J. MOD. AFR. STUD. 289, 295 (2001).

7. Jean Hindricks, Michael Keen & Abhinay Muthoo, *Corruption, Extortion and Evasion*, 74 J. PUB. ECON. 395, 396 n.1 (1999).

8. *See* Pat Widder, *Fairness & Abuse: A Delicate Balance*, CHI. TRIB., Sept. 28, 1997, at C1 ("The IRS is a tax collector, and nobody likes the tax collector.").

9. *See, e.g.*, Erika Hayasaki, *Evading Death and Taxes*, L.A. TIMES, Jul. 20, 2007, at A1 (Tax protestor Ed Brown calls the I.R.S. "the most brutal, ruthless organization out of all there is.").

10. *See, e.g.*, Joseph J. Darby, *Confidentiality and the Law of Taxation*, 46 AM. J. COMP. L. 577, 579 (1998) (stating that the Nixon administration used I.R.S. information to harass political opponents).

11. Tom Herman, *IRS Staffers Tell of Wrongdoing by Fellow Aides*, WALL ST. J., Sept. 26, 1997, at A4 [hereinafter Herman, *IRS Staffers Tell of Wrongdoing*].

12. John M. Broder, *Director of I.R.S. Issues an Apology for Agent Abuses*, N.Y. TIMES, Sept. 26, 1997, at A1 [hereinafter Broder, *Director of I.R.S. Issues Apology*].

ex-husband.[13] I.R.S. employees, their identities hidden, testified that "they had witnessed colleagues bullying taxpayers into submission, using unethical tactics to collect money, and retaliating against IRS workers who tried to correct mistakes."[14] The hearings revealed that I.R.S. agents reviewed the tax records potential witnesses and of jurors in tax cases.[15] Congress also heard that I.R.S. agents had browsed the tax returns of celebrities, relatives, and potential dates, that agents were evaluated based on their total tax collections, and that managers routinely covered up abusive behavior by collection agents.[16]

These alleged abuses by the I.R.S.[17] were salient enough to the legislators and public to lead to a number of reforms of the I.R.S., including the idea of splitting the I.R.S. into two agencies, one of which would collect tax returns and provide advice to taxpayers and the other which would be responsible for audit and enforcement.[18] Ultimately, Congress responded to the horror stories it had heard with the Taxpayer Bill of Rights 3, a collection of over seventy provisions intended to make the I.R.S. more "customer-friendly."[19] These reforms attempted to keep the I.R.S. in check, preventing future abuses and requiring the I.R.S. to treat taxpayers fairly. In general, these changes have made the I.R.S. into a friendlier agency, albeit one with a diminished ability to enforce the tax law.[20]

Although Congress managed to largely check the I.R.S.'s abuse of taxpayers, it has done nothing to prevent the I.R.S. from abusing[21] the tax

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13. Albert B. Crenshaw, *Senate Panel Told of IRS Abuses*, WASH. POST, Sept. 25, 1997, at E03.

14. Herman, *IRS Staffers Tell of Wrongdoing*, *supra* note 11, at A4.

15. Ralph Vartabedian, *IRS Will Review Complaints, End Quotas for Audits*, L.A. TIMES, Sept. 26, 1997, at A1 [hereinafter Vartabedian, *IRS Will Review Complaints*].

16. Broder, *Director of I.R.S. Issues Apology*, *supra* note 12, at A1.

17. The "abuses" are "alleged" because subsequent investigations by the government demonstrated that many of the allegations were either untrue or exaggerated. *See* Leandra Lederman, *Tax Compliance and the Reformed IRS*, 51 U. KAN. L. REV. 971, 979 (2003) [hereinafter Lederman, *Tax Compliance and Reformed IRS*].

18. Vartabedian, *IRS Will Review Complaints*, *supra* note 15, at A1.

19. Lederman, *Tax Compliance and Reformed IRS*, *supra* note 17, at 980–81.

20. *Id.* at 982–83 ("Not surprisingly, the post-RRA '98 reallocation of resources resulted in (or at least coincided with) a significant decline in enforcement activity.").

21. "Abuse" is a strong term, but I have chosen it deliberately. The I.R.S., like any administrative agency, needs a certain amount of flexibility in determining how it will apply its finite resources in enforcing the tax law. *See infra* note 264 and accompanying text. But sometimes it exercises its discretion in a manner that goes beyond choosing how to deploy its resources in the most effective way and, instead,

system. If the I.R.S.'s abuse of the tax system also harms one or more taxpayers, those taxpayers may have recourse to challenge the I.R.S. (though they may have limited incentive to do so), but where no taxpayer suffers direct harm, nothing in the tax law prevents the I.R.S. from misinterpreting or ignoring the law as written.

This Article will examine the I.R.S.'s ability to ignore, misapply, and otherwise abuse the tax law, and propose a way for the tax law to constrain this ability, much as the various Taxpayer Bills of Rights constrained the I.R.S.'s ability to abuse individual taxpayers. Part II presents three examples of I.R.S. abuse of the tax law. In the first, its interpretation harmed specific taxpayers. Even though they had an incentive to challenge the I.R.S.'s interpretation, however, the cost of doing so may have outweighed the potential benefits. In the other two examples, on the other hand, the I.R.S.'s interpretation *benefited* certain taxpayers, while taxpayers collectively bore the costs, leaving nobody with the incentive or the ability to challenge the I.R.S.

Part III discusses the principal way in which Congress oversees the I.R.S. — through oversight boards. The tax law currently provides for the Office of the Taxpayer Advocate, which is charged with highlighting how the I.R.S. can provide better service to taxpayers, and the Internal Revenue Service Oversight Board, which broadly oversees the I.R.S.'s operations.

Part IV then looks at how well an oversight board would fit with the goal of protecting the tax system from I.R.S. abuse. Ultimately, it concludes that, although the Taxpayer Advocate and the I.R.S. Oversight Board are relatively effective in discharging their current mandates, adding the mandate of protecting the tax law to either would be burdensome and ineffective. Congress could create a new oversight board, but such a board would provide suboptimal enforcement.

In Part V, this Article will suggest, instead, that Congress delegate enforcement to taxpayers in general. This type of "fire-alarm oversight" can provide an effective, low-cost method of overseeing the I.R.S. where it interprets the Internal Revenue Code in a way that imposes diffuse cost on taxpayers in general. To effectively delegate such authority will require Congress to provide standing to taxpayers and create both incentives to encourage meritorious claims and disincentives to dissuade frivolous claims. Properly designed, though, such oversight will help rein in I.R.S. abuse of the tax system.

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undermines Congress's purpose in enacting a provision. Though it may not always be clear where to draw the line between *discretion* and *abuse*, just like it can be difficult to draw the line between *zealous enforcement of the tax law* and *taxpayer abuse*, this Article focuses on ways to prevent abuse while preserving the I.R.S.'s necessary discretion.

II. HOW THE IRS ABUSES THE TAX SYSTEM

A. *Reading* And *As* Or

The story of the I.R.S. adopting an incorrect reading of the tax law is not complicated to tell or, theoretically, to resolve. The tax law is complicated and, in places, ambiguous. At times, the I.R.S. errs in its interpretation of the interplay between the language of the Code and what Congress intended for the Code. When it does and uses that misinterpretation to impose a higher tax burden on taxpayers, the affected taxpayers will sue and the courts will overturn the I.R.S.'s misinterpretation. While the process of correcting an I.R.S. misreading of the tax law can follow this narrative, however, the process is often less clean and more problematic than the story would indicate, as illustrated by the I.R.S.'s attempted misapplication of the telephone excise tax.

In 1898, Congress enacted a telephone excise tax to help fund the Spanish-American War.[22] Initially, the one-cent tax applied to long-distance calls that cost more than fifteen cents.[23] Congress repealed the telephone excise tax in 1902, but reinstated it in 1914, as the country began to prepare for World War I.[24] Repealed again in 1924, it once again reappeared in 1932 to make up for diminished federal revenues resulting from the Great Depression.[25] Though Congress has altered its rate structure and base in the years since 1932, the telephone excise tax has continuously applied since then.[26]

Today, the telephone excise tax imposes a three percent tax on three types of "communication services:"[27] local telephone service, toll telephone service, and teletypewriter exchange service.[28] Although the Code specifically defines each type of communication service,[29] the I.R.S. has not seen itself as bound by the Code's definitions.

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22. LOUIS ALAN TALLEY, CONG. RESEARCH SERV., RL 30553, THE FEDERAL EXCISE TAX ON TELEPHONE SERVICE: A HISTORY 1 (2005), http://assets.opencrs.com/rpts/RL30553_20050630.pdf.
23. *Id.*
24. *Id.*
25. *Id.*
26. *Id.*
27. I.R.C. § 4251(a)(1), (b)(2).
28. I.R.C. § 4251(b)(1).
29. I.R.C. § 4252(a)–(c).

In 1979, the I.R.S. released a ruling addressing whether the telephone excise tax applied to satellite calls from ships or other offshore locations to landlines in the United States.[30] The service provider charged callers a per-minute amount, irrespective of their location (and, thus, irrespective of the call's distance).[31] The Code defines toll telephone service as telephone service where the telephone company calculates the price of a call based on the distance and elapsed time of the call.[32] The I.R.S. acknowledged that the satellite phone service did not "[l]iterally . . . come within the definition of 'local telephone service' or 'toll telephone service' as those terms are currently defined in section 4252 of the Code."[33] Nonetheless, it determined that such calls were subject to the tax because the legislative history underlying the tax "indicates that the type of service at issue here is within the intended scope of taxable 'toll telephone service.'"[34] During the 1990s, telephone companies began to broadly offer flat-rate long distance telephone service, with rates based solely on the elapsed time of the call.[35] Based on its earlier revenue ruling, the I.R.S. imposed the telephone excise tax on these calls even though distance played no part in determining the cost of calls.[36] In a series of cases in the mid-2000s, taxpayers challenged the I.R.S.'s application of the telephone excise tax and demanded refunds of the telephone excise taxes they had paid on services.[37] The I.R.S. argued that

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30. Rev. Rul. 79-404, 1979-2 C.B. 382.

31. *Id.*

32. I.R.C. § 4252(b)(1).

33. Rev. Rul. 79-404, 1979-2 C.B. 382.

34. *Id.*

35. Timothy Deering, Note, *A Taxing Statute: Costly Conjuncts and Their Logical Fallout*, 7 CARDOZO PUB. L. POL'Y & ETHICS J. 207, 210 (2008) [hereinafter Deering, *A Taxing Statute*].

36. Rev. Rul. 79-404, 1979-2 C.B. 382 ("The service in this case is essentially 'toll telephone service' as described in section 4252(b)(1) of the Code, even though the charge for calls between remote maritime stations and stations in the United States vary with elapsed transmission time only."); *see also* Notice 2005-79, 2005-2 C.B. 952; Notice 2004-57, 2004-2 C.B. 376.

37. *See* MBNA Am. Bank, N.A. v. United States, 97 A.F.T.R.2d (RIA) 2006-2766 (D. Del. 2006); PNC Bank, N.A. v. United States, 97 A.F.T.R.2d (RIA) 2006-2425 (W.D. Penn. 2006); ServiceMaster Co. v. United States, 2006-1 U.S. Tax Cas. (CCH) ¶ 70,254, 97 A.F.T.R.2d (RIA) 2006-2511 (N.D. Ill. 2006); America Online, Inc. v. United States, 64 Fed. Cl. 571 (Fed. Cl. 2005); Honeywell Int'l, Inc. v. United States, 64 Fed. Cl. 188 (Fed. Cl. 2005); Hewlett-Packard Co. v. United States, 2005-2 U.S. Tax Cas. (CCH) ¶ 70,244, 96 A.F.T.R.2d (RIA) 2005-5953 (N.D. Cal. 2005); Reese Bros. v. United States, 94 A.F.T.R.2d 2004-7229 (W.D. Penn. 2004); Nat'l R.R. Passenger Corp. v. United States, 338 F. Supp. 2d 22 (D.D.C. 2004); Fortis, Inc. v. United States, 420 F. Supp. 2d 166 (S.D.N.Y. 2004); Office Max, Inc. v. United States, 309 F. Supp. 2d 984 (N.D. Ohio 2004); Am.

Congress's use of *and* in the definition of toll service was ambiguous and could function either as a conjunctive or disjunctive.[38] It even issued a proposed regulation that would officially read the *and* in the Code as an *or*.[39] Although the I.R.S. won in the first decided case,[40] it lost each of its subsequent cases.[41] Moreover, the I.R.S.'s sole victory was reversed at the appellate level.[42] Ultimately, taxpayers won in every court of appeals that heard challenges to the I.R.S.'s application of the telephone excise tax.[43]

In May 2005, after its string of losses, the I.R.S. announced that it would no longer litigate these telephone excise tax cases.[44] In 2006, it announced that it would acquiesce to the courts' rulings.[45] In that announcement, it also informed taxpayers of the process they had to follow to request and receive a refund of their overpaid excise tax.[46] The I.R.S. stated that it would refund the tax on nontaxable telephone services billed after February 28, 2003, and before August 1, 2006.[47] Individuals could request either a safe harbor amount or the actual amount of telephone excise tax that they had overpaid.[48] Business entities had no safe harbor, but could claim a refund for the amount they had overpaid.[49] However, taxpayers had to claim the refund on their 2006 tax return.[50]

Bankers Ins. Grp., Inc. v. United States, 308 F. Supp. 2d 1360 (S.D. Fla. 2004), *rev'd*, 408 F.3d 1328 (11th Cir. 2005).

38. *See, e.g.*, *National R.R. Passenger Corp.*, 338 F. Supp. at 26 ("The IRS does not really contest this point, instead focusing on why the Court should construe 'and' to mean 'or' (so that the definition is fulfilled when a toll charge varies in amount with distance *or* time).").

39. 68 Fed. Reg. 15690 (Apr. 1, 2003) ("For a communications service to constitute toll telephone service described in section 4252(b)(1), the charge for the service need not vary with the distance of each individual communication.").

40. *Am. Bankers Ins. Group, Inc.*, 308 F. Supp. 2d at 1373 ("For the foregoing reasons, the Court finds that the statutory language of 26 U.S.C. § 4252(b)(1) is ambiguous and that the clear intent of Congress from before the 1965 amendment up to the present day has been to tax all long-distance telephone service, regardless of whether the toll rate for that service varied only by distance, only by elapsed time, or by both.").

41. Deering, *A Taxing Statute*, *supra* note 35, at 211.

42. Am. Bankers Ins. Group v. United States, 408 F.3d 1328, 1330 (11th Cir. 2005).

43. Annette Nellen, *What's New in Telecom Challenges What's Old in Taxes*, BUS. ENTITIES, Jul.–Aug. 2006, at 3, 8.

44. *Id.* at 10.

45. Notice 2006-50 § 1, 2006-1 C.B. 1141.

46. *Id.* § 5(a)(1).

47. *Id.* § 5(b).

48. *Id.* § 5(c)(1).

49. *Id.* § 5(d)(3)(i).

50. *Id.* § 5(a)(2).

The I.R.S.'s misreading of the tax law here differs in certain significant ways from those cases in which it wrongly grants an extralegal benefit to specific taxpayers.[51] Most saliently, its misreading — in this case, the extra-statutory imposition of the telephone excise tax — not only abused the tax system, it also increased taxpayers' tax bills. As such, some taxpayers had both incentive and standing to challenge the I.R.S.'s position.[52]

In many cases, however, merely having overpaid taxes and possessing standing may prove insufficient incentive for affected taxpayers to police the I.R.S. Only large corporations challenged the imposition of the telephone excise tax, likely because only large corporations paid enough to justify taking the challenge to court. Although it would be difficult to determine how much the I.R.S.'s interpretation of the telephone excise tax cost non-corporate taxpayers, the tax rate was only 3 percent of the cost of the long-distance service.[53] The I.R.S. set its safe harbor refund amount at not more than \$60 per year.[54] Assuming that the \$60 represented a reasonable estimate of the amount an individual taxpayer overpaid, the potential for getting a refund or credit of \$180 would not justify the time and expense of bringing suit for individual taxpayers. The Code imposes a \$60 filing fee on taxpayers who file a case in the Tax Court.[55] If the taxpayer would prefer to file her refund suit in a federal district court or the Court of Federal Claims, she would have to pay a filing fee of \$350.[56]

Civil litigation does have mechanisms to ameliorate the problems of low-value claims. If litigants meet certain requirements, they can file class action suits, which aggregate similar low-value harms, making it worth the litigants' (and their attorneys') time and money to file a suit.[57] In the tax

51. *See infra* Sections II.B. and II.C.

52. Contrast this with the case of the I.R.S.s treatment of tax-exempt entities that endorse candidates and commodities mutual funds, where nobody who has standing has reason to challenge the I.R.S.'s position. *See infra* notes 83–86 and 121–122 and accompanying text.

53. I.R.C. § 4251(a)(1), (b)(2).

54. Notice 2007-11 § 3(b)(2), 2007-1 C.B. 405. The I.R.S. based a taxpayer's safe harbor amount on the number of exemptions on her 2006 tax return. *Id.* § 3(b)(1). A taxpayer with one exemption could request a credit or refund for \$30, with two exemptions could request \$40, with three could request \$50, and with four or more could request \$60. *Id.* § (3)(b)(2).

55. I.R.C. § 7451.

56. 28 U.S.C. §§ 1914(a), 1926(a).

57. *See* Owen M. Fiss, *The Political Theory of the Class Action*, 53 WASH. & LEE L. REV. 21, 24 (1996) ("In short, the class action could be viewed as a device to fund the private attorney general and is able to play that role because of the aggregation of the claims of a large number of persons who have similar or identical claims, none of which — standing alone — would justify the suit.").

world, however, because of the individualized and fact-specific nature of tax refund suits, courts resist certifying class action refund claims.[58]

Even corporations with significant potential refunds may not find a challenge to the I.R.S.'s interpretations worth the cost, however. After the I.R.S. released its refund procedures, several taxpayers sued the I.R.S., arguing that its refund procedure was inadequate because it undercompensated many taxpayers and because it failed to comply with the Administrative Procedure Act's ("APA") notice-and-comment requirements.[59] The court held that the I.R.S. had violated the APA's procedural requirements.[60] It prospectively vacated the I.R.S. notice and remanded the matter to the I.R.S.[61]

Although the plaintiffs won, however, their victory proved costly. The court ultimately denied plaintiffs' interim request for $6.5 million in attorney's fees.[62] Without attorney's fees, plaintiffs won a procedural, but not a financial, victory. Although the suits started as refund suits, the refund portion of the suits had "long since been dismissed."[63] As a result, the taxpayers' victory in having the I.R.S. process vacated was counterbalanced by the cost to the plaintiffs of achieving that result.

The story of the telephone excise tax demonstrates that taxpayers can police the I.R.S. when it incorrectly interprets the tax law, provided the I.R.S.'s interpretation increases the taxpayers' tax liability in comparison to what they should have paid. But it also demonstrates that such policing imposes a cost — potentially significant — on taxpayers. As a result of this cost, they may not have sufficient incentive to challenge the I.R.S.'s misinterpretations, even when they have a strong case. If, instead, Congress provided for some sort of I.R.S. oversight that focused on ensuring that the I.R.S. respected the tax law and preventing it from abusing the law, Congress could limit the expense to taxpayers and the government of litigating the case, and ameliorate the harm to the tax system.

B. Political Campaigning

Congress has exempted certain public charities from the tax rolls. The Code lays out criteria that an organization must meet to qualify for the

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58. *See, e.g.*, Saunooke v. United States, 8 Cl. Ct. 327, 330 (1985) ("This case is particularly ill-suited for class certification by virtue of its status as a tax refund claim.").

59. In re Long-Distance Tel. Serv. Fed. Excise Tax Refund Litig., 853 F. Supp. 2d 138, 141 (D.D.C. 2012).

60. *Id.* at 143.

61. *Id.* at 146.

62. In re Long-Distance Tel. Sev. Fed. Excise Tax Refund Litig., 110 A.F.T.R.2d 2012-6492 (D.D.C. Oct. 29, 2012).

63. *Id.* at 2012-6496.

exemption. An organization that meets these requirements is generally exempt from filing returns and paying taxes. Moreover, because of the unique situation of public charities, donors to these exempt organizations can deduct the amount of their donations in calculating their taxes.[64] Together, the tax exemption and the charitable deduction provide a significant subsidy to public charities.

To qualify for this special treatment, public charities must meet both an organizational and an operational test.[65] To meet the organizational test, a public charity must be organized exclusively for one or more enumerated exempt purposes.[66] The operational test, on the other hand, looks to whether the public charity's primary activities further its exempt purposes.[67] If a public charity fails either the organizational or operational test, it must pay taxes on its income and donors can no longer deduct their donations.[68]

A public charity that campaigns for or against a candidate for office fails the operational test.[69] And the campaigning prohibition is a strict liability provision: even *de minimis* support of a candidate causes a tax-exempt organization to fail.[70] The I.R.S. is the administrative body responsible for enforcing the tax law.[71] When an entity no longer qualifies as tax-exempt, the tax law requires the I.R.S. to revoke its tax exemption.[72] In

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64. A taxpayer's ability to deduct charitable contributions is not, of course, unconstrained. Because charitable contributions are an itemized deduction, taxpayers must first itemize to get a tax benefit from their contributions. Moreover, individuals cannot deduct more than 50 percent of their adjusted gross income (with certain modifications), and corporations cannot deduct more than 10 percent of their taxable income. I.R.C. § 170(b)(1)(A), (2)(A).

65. Reg. § 1.501(c)(3)-1(a)(1).

66. Reg. § 1.501(c)(3)-1(b)(1)(i).

67. Reg. § 1.501(c)(3)-1(c)(1).

68. Reg. § 1.501(c)(3)-1(a)(1).

69. Reg. § 1.501(c)(3)-1(c)(3)(iii); *see also* I.R.C. § 501(c)(3).

70. Anne Berrill Carroll, *Religion, Politics, and the IRS: Defining the Limits of Tax Law Controls on Political Expression by Churches*, 76 MARQ. L. REV. 217, 229 (1992) ("The House OBRA Report explicitly affirmed that the bar on campaign intervention by churches is absolute and that any amount of such conduct renders an organization wholly ineligible for exemption from federal income taxes and receipt of tax-deductible contributions.").

71. *See* Donald B. Tobin, *Political Campaigning by Churches and Charities: Hazardous for 501(c)(3)s, Dangerous for Democracy*, 95 Geo. L.J. 1313, 1358 (2007) [hereinafter Tobin, *Political Campaigning by Churches and Charities*) ("The IRS is charged with enforcing the tax laws and therefore is the federal agency with discretion over whether to begin an examination of a 501(c)(3) organization.").

72. *See* Rev. Rul. 78-248, 1978-1 C.B. 154 ("Organization C is participating in a political campaign in contravention of the provisions of section 501(c)(3) and is disqualified as exempt under that section"). The Treasury Department requested that Congress permit it to have the ability to impose an excise tax on a tax-exempt

addition, the I.R.S. can impose an excise tax on tax-exempt organizations that violate the campaigning prohibition in certain circumstances.[73]

In spite of the prohibition, however, tax-exempt organizations regularly endorse candidates for elective office.[74] Anecdotal evidence, however, suggests that the I.R.S. frequently chooses not to revoke a tax-exempt organization's exemption.[75] In 2004, the I.R.S. examined several cases of alleged campaigning by tax-exempt organizations; in fifty-three of those cases, it determined that the tax-exempt organization had violated the campaigning prohibition, but, rather than revoke the exemption or impose a penalty, it issued a closing letter to the organizations.[76] In four cases, the I.R.S. revoked the tax-exempt organizations exemption, and in three it imposed the excise tax.[77]

Even when faced with a tax-exempt organization's deliberate and flagrant violation of the campaigning prohibition, the I.R.S. often fails to enforce the campaigning prohibition. In 2008, the Alliance Defense Fund created Pulpit Freedom Sunday.[78] On Pulpit Freedom Sunday, participating pastors deliberately flout the campaigning prohibition, preaching a sermon endorsing or opposing a candidate for office.[79] Often, the pastors will then send their sermons directly to the I.R.S., a move which would provide the I.R.S. with evidence of the violation.[80] The number of churches participating in Pulpit Freedom Sunday has grown from thirty-three in 2008 to more than 1,500 in 2012.[81] Notwithstanding the blatantness with which these churches act, however, the I.R.S. has not revoked any exemptions as a result of Pulpit Freedom Sunday.[82]

Although the I.R.S. refuses to fulfill its duty by enforcing the campaigning prohibition, there is no reasonable way to require it to act.

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organization's campaigning in lieu of revoking its exemption, but Congress demurred. *See* A. Mark Christopher, *Political Activities Become More Risky for Tax-Exempts Due to RA '87*, 68 J. TAX'N 136, 138–89 (1988).

73. I.R.C. § 4955.

74. *See, e.g.*, Samuel D. Brunson, *Reigning in Charities: Using an Intermediate Penalty to Enforce the Campaigning Prohibition*, 8 PITT. TAX REV. 125, 150 (2011) [hereinafter Brunson, *Reigning in Charities*].

75. *See, e.g.*, Lloyd Hitoshi Mayer, *Grasping Smoke: Enforcing the Ban on Political Activity by Charities*, 6 FIRST AMEND. L. REV. 1, 12–13 (2007).

76. Brunson, *Reigning in Charities*, *supra* note 74, at 151.

77. *Id.*

78. Stephanie Strom, *The Political Pulpit*, N.Y. Times, Oct. 1, 2011, at B1 [hereinafter Strom, *Political Pulpit*].

79. David Skeel, *Politicking From the Pulpit and the Tax Man*, WALL ST. J., Nov. 22, 2012, at A13 [hereinafter Skeel, *Politicking From the Pulpit*].

80. Strom, *Political Pulpit*, *supra* note 78, at B1.

81. Skeel, *Politicking From the Pulpit*, *supra* note 79, at A13.

82. Strom, *Political Pulpit*, *supra* note 78, at B1.

Recently, the Freedom From Religion Foundation filed a suit requesting the courts to require the I.R.S. to revoke the tax exemption of churches that participated in Pulpit Freedom Sunday, or who otherwise have violated the campaigning prohibition.[83] But such suits are difficult to maintain. To have standing to bring the suit, a taxpayer would need to demonstrate a causal link between the I.R.S.'s refusal to revoke the exemption and a demonstrable harm to the taxpayer.[84] However, unlike the case of the telephone excise tax, the I.R.S.'s refusal to enforce the campaigning prohibition does not harm any particular taxpayer. Rather, the harm is imposed on the tax system itself. As a result, no taxpayer has standing to sue the I.R.S. and force it to enforce the campaigning prohibition.[85]

Without standing to sue, a concerned taxpayer can inform the I.R.S. of the violation. But once the taxpayer has informed the I.R.S., the taxpayer has no further involvement in the case.[86] The I.R.S. will do what it chooses and, if history is any guide, it is unlikely to enforce the prohibition. Because there is no overseer who can require the I.R.S. to do its duty, the I.R.S. has the power to refuse to enforce clear tax law rules.

C. *Commodity Mutual Funds*

The I.R.S. deliberately misreading "and" as "or" in the telephone excise tax is a simple and straightforward story. Likewise, the campaigning prohibition, though controversial, operates in an easily understood manner. By contrast, the story of commodities mutual funds is complicated and

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83. Complaint at 8, Freedom From Religion Foundation, Inc. v. Commissioner, No. 12-CV-818 (W.D. Wis. 2012) ("Ordering the Defendant Shulman and the IRS to forthwith comply with necessary steps to designate an IRS official legally authorized to initiate action against churches and other religious organizations that are reasonably believed to have violated the electioneering restrictions of § 501(c)(3).").

84. *See* Allen v. Wright, 468 U.S. 737, 757 (1984) ("The line of causation between [the I.R.S.'s grant of tax exemption to racially discriminatory private schools] and desegregation of respondents' schools is attenuated at best. From the perspective of the IRS, the injury to respondents is highly indirect and 'results from the independent action of some third party not before the court.'").

85. *See* Tobin, *Political Campaigning by Churches and Charities*, *supra* note 71, at 1358.

86. *Id.* ("Thus, parties who believe a 501(c)(3) organization is violating the political campaign ban send information to the IRS notifying it about the alleged violation. This type of notification is no different than if a person notified the IRS that a neighbor was cheating on her taxes. Once a party informs the IRS about allegedly improper activity, the third party presumably has no further involvement with the complaint.").

requires significantly more explanation, both to understand what happened and why the result harms the tax system.

Corporate shareholders face two levels of taxation on the corporation's income. Corporations pay taxes on their income, then, when they distribute the after-tax income to shareholders, those shareholders pay taxes on the dividends.[87] Because mutual funds are domestic corporations,[88] this double taxation would put mutual fund investors at a significant disadvantage compared with investors who own their investments directly or through an investment partnership.[89] To make a mutual fund investment similar to a direct investment, the tax law permits qualifying mutual funds to deduct from their taxable income the amount of dividends they pay.[90]

A mutual fund does not automatically qualify for this quasi-passthrough tax treatment, however. Rather, it must meet certain criteria imposed by the tax law.[91] A mutual fund that fails to meet these requirements loses its tax-favorable status and pays an entity-level tax, without the ability to deduct its dividends.[92]

Among other things, to qualify for the special tax treatment afforded mutual funds, a mutual fund must earn circumscribed types of income. In essence, a mutual fund must derive at least 90 percent of its income from securities and foreign currencies.[93] It can earn interest or dividends, it can realize gains from the sale of securities, and it can even earn derivative income, as long as that income is related to an investment in securities.[94]

Prior to 1986, though the tax law required mutual funds to derive a significant portion of their income from securities, it contained no definition of "securities."[95] To fill the gaps left by such an important undefined term, the I.R.S. had "often gone beyond the literal terms of the statute," permitting mutual funds to earn money not specifically sanctioned by the Code.[96] To end the I.R.S.'s gap-filling, Congress added a definition of sorts to the Code.

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87. I.R.C. §§ 11(a), 67(a)(7).

88. I.R.C. § 851(a).

89. *See* Samuel D. Brunson, *Mutual Funds, Fairness, and the Income Gap* 8–9, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2131405 (last visited Mar. 26, 2013).

90. I.R.C. § 852(b)(2)(D).

91. *See* I.R.C. § 851(b).

92. *Id.*

93. I.R.C. § 851(b)(2)(A).

94. *Id.*

95. *See, e.g.*, I.R.C. § 851(b)(2) (1954) (to qualify as a RIC, "at least 99% of its gross income is derived from dividends, interest, and gains from the sale or other disposition of stock or securities").

96. Letter from J. Roger Mentz, Acting Assistant Secretary (Tax Policy), to The Hon. Ronnie G. Flippo, House of Representatives, 132 Cong. Rec. 4047, 4047–48 (1986) [hereinafter Mentz, Letter to The Hon. Ronnie G. Flippo].

Rather than directly define "securities," though, Congress chose to insert a cross-reference to the definition from the Investment Company Act of 1940 (the "1940 Act").[97] The 1940 Act defines "security" to include, among other things, notes and other evidences of indebtedness, stock and other evidences of equity interest, and certain derivatives linked to securities.[98] Congress apparently intended this cross-reference to exclude commodities from the set of investments that produces qualifying income.[99]

The legislative history of the mutual fund provisions does not explain why Congress wanted to limit mutual funds' ability to invest in commodities.[100] Still, the law makes clear that Congress intended to prevent

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97. Tax Reform Act of 1986, P.L. 99-514, § 653(b).

98. "'Security' means any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security (including a certificate of deposit) or on any group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a 'security,' or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing." 15 U.S.C. § 80a-2(a)(36).

99. *See, e.g.*, Mentz, Letter to The Hon. Ronnie G. Flippo, *supra* note 96, at 4048 ("[W]e would generally not treat as qualifying income gains from trading in commodities, even if the purpose of that trading is to hedge a related stock investment."); Rev. Rul. 2006-1, 2006-1 C.B. 261 ("The foregoing indicates that Congress did not intend for the cross-reference to the '40 Act to incorporate into section 851(b)(2) an expansive construction of the term 'securities.'").

100. It is possible, however, to speculate as to Congress's reasoning. Perhaps, for example, Congress believed that trading in commodities constituted a trade or business. *See* Lee A. Sheppard, *Mutual Fund Taxation: Putting Square Pegs in Round Holes*, 108 TAX NOTES 58, 60 (2005) [hereinafter Sheppard, *Mutual Fund Taxation*]. Because mutual funds are passive investment vehicles, Congress could view commodity income as antithetical to the passive nature of mutual funds.

Alternatively, Congress may have believed that limiting permissible mutual fund investments to securities kept mutual funds within the realm of expertise of the Securities and Exchange Commission, which regulates both securities and mutual funds. *See, e.g.*, Donald C. Langevoort, *The SEC, Retail Investors, and the Institutionalization of the Securities Market*, 95 VA. L. REV. 1025, 1032 (2009) ("SEC regulation of the securities industry is often described as heavy-handed, overly intrusive and enforcement dominated."); Roberta S. Carmel, *Mutual Funds, Pension Funds, Hedge Funds and Stock Market Volatility—What Regulation by the Securities and Exchange Commission Is Appropriate?*, 80 NOTRE DAME L. REV. 909, 912 (2005) ("[T]he SEC regulates mutual funds . . . ."). If mutual funds could mutual funds from investing extensively in commodities. In spite of Congress's concerns, however, retail investors wanted access to commodity returns.[101] Historically, mutual funds had provided investors with indirect exposure to commodities by investing in the stock of companies that dealt in those commodities.[102] However, the return on commodity companies deviates significantly from the return on commodities futures.[103] Research in the mid-2000s, however, suggested that direct commodity investments dampened the volatility generally associated with commodities.[104] And by the mid-2000s, a number of mutual funds had stepped in to fill that demand.[105]

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only invest in securities, their investments would line up with their key regulator. Still, even if the Securities and Exchange Commission could not regulate a mutual fund's commodities investments, those investments would not go unregulated. Instead, they would fall under the jurisdiction of the Commodities Futures Trading Commission, just like any other investor's commodities investments. *See* Jerry W. Markham, *Prohibited Floor Trading Activities Under The Commodity Exchange Act*, 58 FORDHAM L. REV. 1, 4 (1989).

Congress may, instead, have acted with a paternalistic impulse. "Mutual funds are designed for unsophisticated investors who cannot assemble a diversified portfolio or evaluate the mutual fund's portfolio." Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10, 20 (1991). As a result, the regulation of mutual funds intends to "protect[] the public, whose funds have been intrusted to the investment managers." COMM. ON BANKING AND CURRENCY, STOCK EXCHANGE PRACTICES, S. Rep. No. 73-1455, at 363 (1934). Commodities markets tend to be volatile and risky. Robert S. Pindyck, *Volatility and Commodity Price Dynamics*, 24 J. FUTURES MKTS. 1029, 1029 (2004). Congress may have decided to protect mutual fund investors from the volatility inherent in commodities investments by preventing mutual funds from significantly investing in commodities.

101. *See, e.g.*, Tim Gray, *Sold on Pork Bellies (and Other Commodities)*, N.Y. TIMES, Oct. 10, 2010, at BU13 (stating that "commodities have become an investing vogue"); Conrad de Aenlle, *Have Commodities Become the New Tech Stocks?*, N.Y. TIMES, Feb. 5, 2006, § 3, at 5.

102. Tim Gray, *Is It Too Late to Ride the Energy Bandwagon?*, N.Y. TIMES, Oct. 9, 2005, § 3, at 25 [hereinafter Gray, *Too Late to Ride the Energy Bandwagon*] ("He says he has reduced the fund's ups and downs by allocating fewer dollars to oil-related stocks than many of his peers, instead favoring such companies as Newmont Mining, a gold producer, and even Nucor, a steel maker.").

103. Gary Gorton & Geert Rouwenhorst, *Facts and Fantasies about Commodity Futures*, 62 FIN. ANALYSTS J. 47, 60 (Mar.-Apr. 2006) ([T]he correlation between [commodities futures and commodity companies] was only 0.40.").

104. *Id.* ("[T]he historical risk of an investment in commodity futures has been relatively low . . . .").

105. *See, e.g.*, Gray, *Too Late to Ride the Energy Bandwagon*, *supra* note 102, at 25 ("Several companies, including Pimco in Newport Beach, Calif., and OppenheimerFunds in New York, offer mutual funds that invest in commodities.").

Though mutual funds faced significant impediments on their ability to invest in commodities, they attempted to circumvent the prohibition by investing in swaps on commodity indices. A commodity index is essentially a measure of the value of a basket of commodities, with each commodity assigned a certain weight within the basket.[106] The index reflects the value of the specified commodities; it does not, however, constitute an ownership interest in those commodities.[107] A swap is a financial instrument that seeks to provide synthetic (though not legal) ownership of a financial asset or index. One party to the swap — the long party — believes that the asset will increase in value, while the other — the short party — bets that its value will fall.[108]

Under the terms of these commodity index swaps, a commodity mutual fund would take the long position in the swap, agreeing to pay its counterparty interest and any depreciation on the index. In return, the counterparty would pay the amount of any appreciation in the index to the mutual fund.[109] By investing in these swaps, a commodity mutual fund synthetically recreates an investment in the basket of commodities represented by its chosen index. Its investors have direct exposure to the value of the commodities, rather than an indirect approximation of their return through equity investments in commodity-producing companies.

Of course, this strategy only works if the commodity index swaps qualify as "securities" for tax purposes. Otherwise, a mutual fund cannot derive more than 10 percent of its income from such swaps (and from any other assets it owns that do not qualify as securities). While the SEC did not rule on whether commodity index swaps qualified as securities under the 1940 Act, it had issued no-action letters that permitted funds to treat certain commodity-related dividends as securities for 1940 Act purposes.[110] The

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106. Ke Tang & Wei Xiong, *Index Investment and Financialization of Commodities* 6 (Nat'l Bureau Econ. Res., Working Paper No. 16385, 2010), http://papers.nber.org/tmp/16489-w16385.pdf.

107. *See, e.g.*, Wai Mun Fong & Kim Hock See, *Modelling the Conditional Volatility of Commodity Index Futures as a Regime Switching Process*, 16 J. APPLIED ECONOMETRICS 133, 136 (2001) ("The GSCI is an index of 'spot prices' or, more precisely, prices of nearest futures contracts for a basket of commodities representing all commodity sectors such as energy, metals, livestock and agricultural products.").

108. Samuel D. Brunson, *Elective Taxation of Risk-Based Financial Instruments: A Proposal*, 8 HOUS. BUS. & TAX L.J. 1, 8 (2007) ("Very generally, swaps call for . . . payments between counterparties, based on the movement of an objective financial reference.").

109. Sheppard, *Mutual Fund Taxation*, *supra* note 100, at 61.

110. *See, e.g.*, Mallory Randall Corp., SEC No-Action Letter, Fed. Sec. L. Rep. (CCH) No. 102080058 (Oct. 3, 1980) (treating options on commodities as securities for purposes of section 2(a)(36) of the 1940 Act); Thomas Beard, SEC No-

commodity mutual funds received opinions of counsel, based on this SEC precedent, that they could treat commodity index swaps as securities for tax purposes, and that they produced qualifying income.[111]

However, commodity mutual funds received a blow at the beginning of 2006. The I.R.S. issued a Revenue Ruling in which it held that commodity index swaps did not qualify as securities for purposes of the tax law.[112] Because the returns on commodity index swaps derived from the value of commodities, not securities, excluding them from the set of assets that produced qualifying income fit comfortably within Congress's intent. Thus, the I.R.S. disqualified such swaps.

Within the year, however, the funds figured out two paths they could use to gain direct exposure to commodities for their investors: commodity-linked notes and wholly-owned tax-haven subsidiaries. And not only did the I.R.S. not object to these investments, it explicitly permitted mutual funds to count such investments as securities for purposes of mutual fund qualifications. In doing so, it ignored the plain language of the tax law.

Like commodity index swaps, commodity-linked notes provide investors with a return based on an index of commodities. Formally, a commodity-linked note is a debt instrument issued by a corporation. Unlike a plain-vanilla note, however, a commodity-linked note does not necessarily pay an investor its face amount upon maturity. Instead, when it matures, the owner of a commodity-linked note can exchange that note for the face amount of the bond or the value of the underlying commodities.[113] Like commodity index swaps, commodity-linked notes allow investors to gain exposure to individual commodities or baskets of commodities. Corporations issue commodity-linked notes in order to share the potential appreciation in commodities with investors in exchange for paying a lower interest rate.[114]

On April 10, 2006, the I.R.S. released a private letter ruling holding that commodity-linked notes would qualify as securities for purposes of mutual fund qualification.[115] And between 2006 and 2011, the I.R.S. issued at

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Action Letter, Fed. Sec. L. Rep. (CCH), 1975 WL 367603 (May 8, 1975) (same); Far West Futures Fund, SEC No-Action Letter, Fed. Sec. L. Rep. (CCH), 1974 WL 351250 (Sept. 4, 1974) (same).

111. Sheppard, *Mutual Fund Taxation*, *supra* note 100, at 60.

112. Rev. Rul. 2006-1, 2006-1 C.B. 262.

113. Peter Carr, *A Note on the Pricing of Commodity-Linked Bonds*, 42 J. FIN. 1071, 1071 (1987).

114. Eduardo S. Schwartz, *The Pricing of Commodity-Linked Bonds*, 37 J. FIN. 525, 525 (1982).

115. Priv. Ltr. Rul. 2006-28-001 (Apr. 10, 2006). The fact that the I.R.S. issued a private letter ruling does not mean that the tax law recognizes commodity-linked notes as a security for purposes of mutual fund qualification. A private letter ruling is merely a ruling issued by the I.R.S. to a specific taxpayer in response to that taxpayer's request. *See* Julie A. D. Manasfi, *The Global Shadow Bank — Systemic*

least thirty-seven more private letter rulings blessing mutual funds' investments in commodity-linked notes.[116] Shortly after the I.R.S. began permitting mutual funds' investments in commodity-linked notes, funds began to explore investing in wholly-owned foreign subsidiaries that, in turn, invested in various commodity-linked instruments.[117] As with commodity-

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Risk and Tax Policy Objectives: The Uncertain Case of Foreign Hedge Fund Lending to U.S. Borrowers and Transacting in U.S. Debt Securities, 11 FLA. TAX REV. 643, 658 n.49 (2011) ("Private Letter Rulings are taxpayer specific rulings furnished by the IRS in response to requests made by taxpayers and cannot be used as precedent."). A private letter ruling issued to one taxpayer has no precedential value to another taxpayer. I.R.C. § 6110(k)(3); *see also* Rev. Proc. 2012-1 § 11.02 ("A taxpayer may not rely on a letter ruling issued to another taxpayer."); Goodstein v. Commissioner, 267 F.2d 127, 132 (1st Cir. 1959) ("[T]o hold that the Commissioner is bound by rulings specifically addressed to a taxpayer other than the one whose return is questioned would severely limit the usefulness of the long established practice of private administrative rulings."). Still, private letter rulings provide an indication of the I.R.S.'s current position on the law. *See, e.g.*, *id.* ("The taxpayer contends that although these letters were not addressed to him they were shown to him by Livingstone and he relied upon their approval of transactions which would seem to be essentially undistinguishable from that presented here."). Moreover, given the number of private letter rulings the I.R.S. has issued on this point, it appears to be a position in which the I.R.S. believes.

116. *See* Priv. Ltr. Rul. 2011-35-001 (May 23, 2011); Priv. Ltr. Rul. 2011-31-001 (Apr. 18, 2011); Priv. Ltr. Rul. 2011-13-015 (Dec. 8, 2010); Priv. Ltr. Rul. 2011-08-003 (Nov. 15, 2010); Priv. Ltr. Rul. 2011-08-018 (Nov. 15, 2010); Priv. Ltr. Rul. 2011-04-013 (Oct. 20, 2010); Priv. Ltr. Rul. 2011-03-019 (Oct. 14, 2010); Priv. Ltr. Rul. 2011-03-033 (Oct. 12, 2010); Priv. Ltr. Rul. 2011-02-055 (Sept. 22, 2010); Priv. Ltr. Rul. 2011-07-012 (Sept. 21, 2010); Priv. Ltr. Rul. 2010-43-016 (July 15, 2010); Priv. Ltr. Rul. 2010-39-002 (June 22, 2010); Priv. Ltr. Rul. 2010-37-012 (June 4, 2010); Priv. Ltr. Rul. 2010-30-004 (Apr. 28, 2010); Priv. Ltr. Rul. 2010-34-011 (Apr. 23, 2010); Priv. Ltr. Rul. 2010-31-007 (Apr. 13, 2010); Priv. Ltr. Rul. 2010-25-031 (Feb. 23, 2010); Priv. Ltr. Rul. 2009-52-019 (Sept. 13, 2009); Priv. Ltr. Rul. 2009-46-036 (July 8, 2009); Priv. Ltr. Rul. 2009-39-017 (June 4, 2009); Priv. Ltr. Rul. 2009-31-003 (Apr. 16, 2009); Priv. Ltr. Rul. 2009-31-008 (Apr. 16, 2009); Priv. Ltr. Rul. 2009-12-003 (Nov. 19, 2008); Priv. Ltr. Rul. 2008-45-013 (July 30, 2008); Priv. Ltr. Rul. 2008-42-014 (July 17, 2008); Priv. Ltr. Rul. 2008-40-039 (June 13, 2008); Priv. Ltr. Rul. 2008-31-019 (Apr. 18, 2008); Priv. Ltr. Rul. 2008-22-012 (Feb. 12, 2008); Priv. Ltr. Rul. 2007-45-008 (Aug. 2, 2007); Priv. Ltr. Rul. 2007-26-026 (Mar. 16, 2007); Priv. Ltr. Rul. 2007-20-011 (Feb. 2, 2007); Priv. Ltr. Rul. 2007-05-026 (Oct. 31, 2006); Priv. Ltr. Rul. 2007-01-020 (Sept. 26, 2006); Priv. Ltr. Rul. 2006-47-017 (Aug. 10, 2006); Priv. Ltr. Rul. 2007-45-021 (June 20, 2006); Priv. Ltr. Rul. 2012-06-015 (June 13, 2006); Priv. Ltr. Rul. 2006-37-018 (June 1, 2006).

117. Because the wholly-owned subsidiaries are organized in tax haven jurisdictions, they owe no local taxes on their commodities income. *See* Samuel D. Brunson, *Repatriating Tax-Exempt Investments: Tax Havens, Blocker Corporations,*

linked notes, the I.R.S. proved willing to issue private letter rulings holding that income from such subsidiaries constituted qualifying income.[118] Through

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and Unrelated Debt-Financed Income, 106 NW. U. L. REV. 225, 239 (2012). As such, holding an investment through a tax haven corporation does not produce an additional layer of taxes. Moreover, because the subsidiary is wholly owned by the commodity mutual fund, its existence is unlikely to provide any downside protection to investors, who already have limited liability by virtue of the mutual fund itself.

What protection it does offer, moreover, is more illusory than real. While a counterparty cannot compel the mutual fund parent to make it whole, in most cases it does not need to. Rather, derivatives clearinghouses generally require parties to derivatives — including commodities-related dividends — to put money into a margin account when they enter into a transaction. *See* Adam H. Rosenzweig, *Imperfect Financial Markets and the Hidden Costs of a Modern Income Tax*, 62 SMU L. REV. 239, 255 (2009) ("[T]he clearinghouse requires investors to post margin with the clearinghouse prior to investing in a derivative, which serves as security on the embedded contingent liability in the derivative position."). The margin account serves to ameliorate the risk that the subsidiary will not meet its obligations. And, while a margin account does not undo limited liability, it does require that the commodities mutual fund capitalize its subsidiary sufficiently to meet the margin requirement. Because the mutual fund has to capitalize its subsidiary at a higher rate, it puts more of its own capital at risk, and, as such, more of its assets are at risk on the commodities transactions.

118. *See* Priv. Ltr. Rul. 2012-06-015 (Feb. 10, 2012); Priv. Ltr. Rul. 2011-34-014 (Aug. 26, 2011); Priv. Ltr. Rul. 2011-32-008 (Aug. 12, 2011); Priv. Ltr. Rul. 2011-31-001 (Aug. 5, 2011); Priv. Ltr. Rul. 2011-29-002 (July 22, 2011); Priv. Ltr. Rul. 2011-28-022 (July 15, 2011); Priv. Ltr. Rul. 2011-22-012 (June 3, 2011); Priv. Ltr. Rul. 2011-20-017 (May 20, 2011); Priv. Ltr. Rul. 2011-16-014 (Apr. 22, 2011); Priv. Ltr. Rul. 2011-13-018 (Apr. 1, 2011); Priv. Ltr. Rul. 2011-08-018 (Feb. 25, 2011); Priv. Ltr. Rul. 2011-08-008 (Feb. 25, 2011); Priv. Ltr. Rul. 2011-07-012 (Feb. 18, 2011); Priv. Ltr. Rul. 2011-04-013 (Jan. 28, 2011); Priv. Ltr. Rul. 2011-03-033 (Jan. 21, 2011); Priv. Ltr. Rul. 2011-03-009 (Jan. 21, 2011); Priv. Ltr. Rul. 2011-03-017 (Jan. 21, 2011); Priv. Ltr. Rul. 2011-02-047 (Jan. 14, 2011); Priv. Ltr. Rul. 2011-02-055 (Jan. 14, 2011); Priv. Ltr. Rul. 2010-51-014 (Dec. 23, 2010); Priv. Ltr. Rul. 2010-49-015 (Dec. 10, 2010); Priv. Ltr. Rul. 2010-48-021 (Dec. 3, 2010); Priv. Ltr. Rul. 2010-48-022 (Dec. 3, 2010); Priv. Ltr. Rul. 2010-43-017 (Oct. 29, 2010); Priv. Ltr. Rul. 2010-42-015 (Oct. 22, 2010); Priv. Ltr. Rul. 2010-42-001 (Oct. 22, 2010); Priv. Ltr. Rul. 2010-41-033 (Oct. 15, 2010); Priv. Ltr. Rul. 2010-39-002 (Oct. 1, 2010); Priv. Ltr. Rul. 2010-37-012 (Sept. 17, 2010); Priv. Ltr. Rul. 2010-37-014 (Sept. 17, 2010); Priv. Ltr. Rul. 2010-34-011 (Aug. 27, 2010); Priv. Ltr. Rul. 2010-30-004 (July 30, 2010); Priv. Ltr. Rul. 2010-26-017 (July 2, 2010); Priv. Ltr. Rul. 2010-25-031 (June 25, 2010); Priv. Ltr. Rul. 2010-24-003 (June 18, 2010); Priv. Ltr. Rul. 2010-24-004 (June 18, 2010); Priv. Ltr. Rul. 2010-20-003 (May 21, 2010); Priv. Ltr. Rul. 2010-07-044 (Feb. 19, 2010); Priv. Ltr. Rul. 2010-05-023 (Feb. 5, 2010); Priv. Ltr. Rul. 2009-47-026 (Nov. 20, 2009); Priv. Ltr. Rul. 2009-47-032 (Nov. 20, 2009); Priv. Ltr. Rul. 2009-46-036 (Nov. 13, 2009); Priv. Ltr. Rul. 2009-39-017 (Sept. 25, 2009); Priv. Ltr. Rul. 2009-36-002 (Sept. 4, 2009); Priv. Ltr. Rul. 2009-32-007 (Aug. 7, 2009); Priv. Ltr. Rul. 2009-31-003 (July 31, 2009); Priv. Ltr.

these subsidiaries, mutual funds could access the commodities market using instruments that would not have produced qualifying income if held directly by the mutual funds, including the commodity index swaps the I.R.S. had previously disallowed.[119]

The I.R.S. never explained why it considers commodity-linked notes to qualify as securities, while it does not consider commodity index swaps to so qualify. Likewise, it never explained why it does not permit a direct investment in commodity index swaps, but is comfortable with an indirect investment through a wholly-owned subsidiary. Though the details of the investments differ, they present essentially the same risk and the same reward.

Even if the economics of the two instruments differed radically, though, that would not justify treating them differently. The revenue ruling held that a commodity index swap did not qualify as a security "because the underlying property is a commodity (or commodity index)."[120] The property underlying a commodity-linked note is *exactly the same* as the property underlying a commodity index swap. Commodity mutual funds invest in commodity-linked notes precisely because such notes provide them with exposure to commodities. Because both the economics and the underlying property of commodity index swaps and commodity-linked notes differ only formally, if at all, it would seem incumbent on the I.R.S. to explain its disparate treatment of the two. But it has provided no such explanation.

The problems of policing the I.R.S. in cases like the commodities mutual funds presents even more problems than examples like the telephone excise tax and the campaigning prohibition. Here, the I.R.S. is not merely refusing to enforce the tax law: by issuing favorable private letter rulings, it has indicated that it considers the taxpayer's position to be acceptable. If it finds the position acceptable it will not challenge the position. Because the I.R.S. functions both as the promulgator of the rulings and the enforcer of the tax law, it will be ineffective at preventing itself from enforcing the tax law incorrectly.

Rul. 2009-31-008 (July 31, 2009); Priv. Ltr. Rul. 2009-23-011 (June 5, 2009); Priv. Ltr. Rul. 2009-22-010 (May 29, 2009); Priv. Ltr. Rul. 2009-12-003 (Mar. 20, 2009); Priv. Ltr. Rul. 2008-42-014 (Oct. 17, 2008); Priv. Ltr. Rul. 2008-40-039 (Oct. 3, 2008); Priv. Ltr. Rul. 2008-22-010 (May 30, 2008); Priv. Ltr. Rul. 2007-43-005 (Oct. 26, 2007); Priv. Ltr. Rul. 2007-41-004 (Oct. 12, 2007); Priv. Ltr. Rul. 2006-47-017 (Nov. 24, 2006).

119. *See, e.g.*, Priv. Ltr. Rul. 2012-06-015 (June 13, 2006) ("Each Subsidiary will invest primarily in commodity index swap agreements and fixed income securities, and may also invest in other commodity-linked instruments, including swap agreements on commodities, options, futures contracts, options on futures, and commodity-linked notes.").

120. Rev. Rul. 2006-1, 2006-1 C.B. 261.

Recipients of the private letter rulings are also in no position to police the I.R.S. The recipient taxpayer has expended significant time and resources in applying for and receiving the ruling.[121] Moreover, private letter rulings allow the taxpayer to structure her transaction in a specific way, knowing that the I.R.S. will not generally challenge her anticipated tax treatment.[122] Inasmuch as a successfully-obtained private letter ruling provides a benefit to the taxpayer who received it, that taxpayer has no incentive to challenge the ruling.

Moreover, non-party taxpayers also lack standing to challenge these private letter rulings. Though the I.R.S.'s commodity mutual fund rulings "are arguably more generous than [the] statute, resulting in forgone revenue to the federal fisc, for which we all pay indirectly," such indirect harm does not provide non-party taxpayers with standing.[123] Instead, to have standing to challenge an I.R.S. tax ruling, a taxpayer "must suffer a tangible injury."[124]

III. CURRENT OVERSIGHT OF THE I.R.S.

As the prior Section has demonstrated, the I.R.S. does not always enforce the tax law as written. Sometimes the I.R.S.'s departure from the law as written harms taxpayers; even when it does not, however, it harms the tax system and violates Congress's intent.

The I.R.S.'s departure from Congressional intent is a standard principal-agent problem.[125] Congress, as the principal, promulgates the tax law. It does not, however, actively participate in the law it has promulgated; rather, it leaves the administration and enforcement to the I.R.S. which, in

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121. A private letter ruling can cost a taxpayer tens of thousands of dollars to obtain. To request a private letter ruling, a taxpayer must pay a fee (which, in 2012, was $18,000). Rev. Proc. 2012-1, 2012-1 I.R.B. 1, 69. On top of the fee to the I.R.S., a taxpayer must pay the professionals that prepare the ruling request. Moreover, in addition to the cost, private letter rulings take time to process, which delays a mutual fund's ability to engage in its desired transactions. *See* Thomas Kelley, *Law and Choice of Entity on the Social Enterprise Frontier*, 84 TUL. L. REV. 337, 356 (2009).

122. Treas. Reg. § 601.201(l)(6) ("A ruling issued to a taxpayer with respect to a particular transaction represents a holding of the Service on that transaction only.").

123. Leandra Lederman, *What Do Courts Have to Do With It?: The Judiciary's Role in Making Federal Tax Law*, 65 NAT'L TAX J. 899, 910 (2012).

124. Greg D. Polsky, *Can Treasury Overrule the Supreme Court?*, 84 B.U. L. REV. 185, 239 (2004).

125. *See, e.g.*, Sanford J. Grossman & Oliver D. Hart, *An Analysis of the Principal-Agent Problem*, 51 ECONOMETRICA 7, 7 (1983).

spite of being an executive agency, functions as Congress's agent.[126] Congress does not, however, have the resources to fully oversee the I.R.S., and must therefore establish incentives to ensure that the I.R.S. enforces the tax law in the manner Congress desires.[127]

Although the I.R.S. generally succeeds in fulfilling its duties in administering the tax law, the current incentive system functions imperfectly. Whatever the reason, at times the I.R.S. will misinterpret or ignore wholesale the law it has been charged with administering.[128] To prevent such behavior, Congress needs to modify the I.R.S.'s incentives. In the past, Congress has established boards and offices to oversee the I.R.S. The principal oversight mechanisms Congress has established are the Office of the Taxpayer Advocate and the Internal Revenue Service Oversight Board.

A. The Office of the Taxpayer Advocate

With proper design, the I.R.S. itself could fulfill the necessary oversight role. In response to various taxpayer complaints about the I.R.S., Congress has enacted various reforms over the last three decades intended to check the I.R.S.'s purported abuses of taxpayers.[129] In 1979, the I.R.S. created the Office of the Taxpayer Ombudsman to coordinate its problem resolution program and to act as an advocate for taxpayers.[130] In 1988, Congress enacted the Taxpayer Bill of Rights, which, among other things, codified the Taxpayer Ombudsman and gave it the ability to issue a Taxpayer

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126. Archie Parnell, *Congressional Interference in Agency Enforcement: The IRS Experience*, 89 YALE L.J. 1360, 1360 (1980) [hereinafter Parnell, *Congressional Interference in Agency Enforcement*] ("[T]he relationship remains one of interdependence, in which Congress depends on the IRS to execute the Internal Revenue Code and collect the revenues necessary to fund the federal government and the IRS depends on Congress to fund and authorize its operations . . . .").

127. David E. M. Sappington, *Incentives in Principal-Agent Relationships*, 5 J. ECON. PERSP. 45, 45 (1991) ("Incentive theory, however, generally focuses on tasks that are too complicated or too costly to do oneself. Thus, the 'principal' is obliged to hire an 'agent' with specialized skills or knowledge to perform the task in question.").

128. At times, of course, Congress itself may impede the I.R.S. from doing its job appropriately, forbidding it to enforce certain provisions of the Code rather than legislatively changing the Code. *See, e.g.*, Parnell, *Congressional Interference in Agency Enforcement*, *supra* note 126, at 1361 ("Second, Congress has shown a recent tendency to use a variety of techniques to prohibit the IRS from executing certain aspects of the Code, rather than changing the Code itself.").

129. *See supra* notes 17–20 and accompanying text.

130. Bryan T. Camp, *What Good Is the National Taxpayer Advocate?*, 126 TAX NOTES 1243, 1247 (2010) [hereinafter Camp, *National Taxpayer Advocate*].

Assistance Order.[131] A Taxpayer Assistance Order could require the I.R.S. to release taxpayer property it had levied, prevent collection, and otherwise protect taxpayers suffering significant hardship as a result of the I.R.S.'s administration of the tax law.[132] In addition, Congress required the Taxpayer Ombudsman to make an annual report to the Senate Finance Committee and the House Ways and Means Committee on the quality of taxpayer services.[133]

In 1996, Congress replaced the Office of the Taxpayer Ombudsman with the Office of the Taxpayer Advocate.[134] The Office of the Taxpayer Advocate was supervised by the Taxpayer Advocate, who reported directly to the Commissioner of Internal Revenue.[135] The Code continued to require the Office of the Taxpayer Advocate to make an annual report to Congress and to help taxpayers resolve problems with the I.R.S.[136] In addition, the Taxpayer Bill of Rights 2 charged the newly-created Office of the Taxpayer Advocate with identifying problem areas in taxpayer interaction with the I.R.S. and proposing administrative and legislative changes that could fix those problem areas.[137]

In spite of these changes, many in Congress did not believe that that the Taxpayer Advocate functioned independently from the I.R.S. as it advocated for taxpayers.[138] Their incredulity stemmed, at least in part, "on the placement of the Advocate within the IRS and the fact that only career employees have been chosen to fill the position."[139] In 1998, Congress further tweaked the Office of the Taxpayer Advocate in an attempt to ensure the Taxpayer Advocate's independence.[140] The head of the Office of the Taxpayer Advocate was rechristened the National Taxpayer Advocate.[141] Though she continues to report directly to the Commissioner of Internal Revenue,[142] Congress attempted to ensure her independence by prohibiting the appointment as National Taxpayer Advocate of anybody who had worked

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131. Technical and Miscellaneous Revenue Act of 1988 ("TAMRA"), Pub. L. No. 100-647, Title VI, 102 Stat. 3342, 3733 (1988).

132. I.R.C. § 7811(b).

133. TAMRA, Pub. L. No. 100-647, Sec. 6235 (b), 102 Stat. 3342, 3737 (1988).

134. Taxpayer Bill of Rights 2, 104 P.L. 168, § 101(a), 110 Stat. 1452, 1453 (1996).

135. *Id.*

136. *Id.*

137. *Id.*

138. NAT'L COMM'N ON RESTRUCTING THE I.R.S., A VISION FOR A NEW IRS 48 (June 25, 1997) [hereinafter NAT'L COMM'N, VISION].

139. *Id.*

140. I.R.S. Restructuring and Reform Act of 1998, Pub. L. No. 105-206, § 1102, 12 Stat. 685, 697 (1998).

141. I.R.C. § 7803(c)(1)(B)(i).

142. *Id.*

for the I.R.S. in the prior two years. Moreover, the National Taxpayer Advocate must agree not to accept a job with the I.R.S. for five years after her appointment as National Taxpayer Advocate ends.[143] As a result of these limitations, the National Taxpayer Advocate cannot view her service as "just another assignment . . . , with the Commissioner viewing . . . her performance as determining the next position."[144]

In addition, Congress provided for local taxpayer advocates, including one for each state.[145] Each of these local offices must have its own phone, fax, and other electronic communication, separate from the I.R.S.[146] Each must inform taxpayers of its independence from any other I.R.S. office at the beginning of its consultation and, importantly, each has the discretion not to disclose to the I.R.S. the fact that a taxpayer had contact with the office or any information provided by the taxpayer.[147]

The Office of the Taxpayer Advocate claims to be the "voice of the taxpayer."[148] Does it manage to effectively pursue taxpayer interests, even where those interests conflict with the I.R.S.'s goals? Though the data is limited, anecdotally, it appears to work. Practitioners praise the Taxpayer Advocate for "get[ing] things done despite the impediments of the systems within the IRS."[149] Moreover, in spite of the tensions inherent in an ombudsman-type role,[150] the Taxpayer Advocate's customer service surveys indicate that even taxpayers who do not obtain the results they wanted feel better about the I.R.S. after working with the Taxpayer Advocate.[151] Current National Taxpayer Advocate Nina Olson sees the Office of the Taxpayer Advocate successfully navigating the tension between being an insider and an outsider in part because the Taxpayer Advocate is just that — an advocate, not a decision-maker.[152]

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143. *Id.* § 7803(c)(1)(B)(iv).

144. NAT'L COMM'N, VISION, *supra* note 138, at 48.

145. I.R.C. § 7803(c)(2)(D)(i)(I).

146. *Id.* § 7803(c)(4)(B).

147. *Id.* § 7803(c)(4)(A).

148. NAT'L TAXPAYER ADVOCATE, FISCAL YEAR 2013 OBJECTIVES I-3 (2012), http://www.taxpayeradvocate.irs.gov//usersfiles/file/FY13ObjectivesReporttoCongress.pdf.

149. Larry Jones, *Customer Service—We All Want It, But Do We Get It?*, J. TAX PRAC. & PROC., Aug.-Sept. 2003, at 5, 8.

150. *See, e.g.*, Camp, *National Taxpayer Advocate*, *supra* note 130, at 1250 ("Few people like being criticized, and there is an inherent distrust within a bureaucracy of a subcomponent like the TAS whose very function is to highlight problems in the system, whether case specific or systemic.").

151. Nina Olson, *The Taxpayer Advocate Service: Independence Within the IRS*, 126 TAX NOTES 1257, 1261 (2010) [hereinafter Olson, *Taxpayer Advocate*].

152. *Id.* at 1260.

B. *The Internal Revenue Service Oversight Board*

Congress can also place the oversight duty and authority outside of the I.R.S. itself. For example, Congress created the Internal Revenue Service Oversight Board in the same 1998 law that restructured the Office of the Taxpayer Advocate.[153] The Oversight Board consists of nine members.[154] The president appoints seven members with the advice and consent of the Senate; of those seven, six cannot be federal officers or employees.[155] These board members were to be "high stature, nonpartisan professionals, with experience particularly relevant to a 100,000 employee organization."[156] The seventh board slot appointed by the President is filled by a full-time federal employee or a representative of federal employees.[157] The Secretary of the Treasury Department and the Commissioner of Internal Revenue fill the other two board seats.[158] The Oversight Board is non-partisan, and its members must have experience and expertise in, among other things, federal tax law, including compliance and administration.[159]

The Code charges the Oversight Board with overseeing the I.R.S. "in its administration, management, conduct, direction, and supervision of the execution and application of the internal revenue laws or related statutes and tax conventions to which the United States is a party."[160] More specifically, the Oversight Board must review the I.R.S.'s strategic and operational plans, recommend and oversee the Commissioner of Internal Revenue, review and approve the I.R.S.'s budget, and ensure that I.R.S. employees treat taxpayers properly.[161]

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153. I.R.S. Restructuring and Reform Act of 1998, Pub. L. No. 105-206, § 1101(a), 12 Stat. 685, 691 (1998).

154. I.R.C. § 7802(b)(1).

155. *Id.* § 7802(b)(1)(A).

156. NAT'L COMM. ON RESTRUCTURING THE INTERNAL REVENUE SERVICE, REPORT OF THE NAT'L COMM. ON RESTRUCTURING THE INTERNAL REVENUE SERVICE: A VISION FOR A NEW IRS 13 (1997) http://www.house.gov/natcommirs/report1.pdf, [hereinafter NAT'L COMM., RESTRUCTURING].

157. I.R.C. § 7802(b)(1)(D).

158. *Id.* § 7802(b)(1)(B)-(C).

159. *Id.* § 7802(b)(2)(A)(iii).

160. *Id.* § 7802(c)(1)(A).

161. *Id.* § 7802(c)(2)-(5). Congress has not limited its use of oversight committees to the world of tax. An alternative model comes from bankruptcy. In 1978, Congress established the Office of the United States Trustee to handle the administrative functions of bankruptcy, while also reducing certain abuses within the bankruptcy system as a whole. Greg M. Zipes, *Discovery Abuse in the Civil Adversary System: Looking to Bankruptcy's Regime of Mandatory Disclosure and Third-Party Control Over the Discovery Process for Solutions*, 27 CUMB. L. REV. 1107, 1160 (1996). The U.S. Trustee has the authority both to monitor bankruptcy cases, but to take action when, for example, a case risks undue delay or when parties

IV. SUBOPTIMAL OVERSIGHT

Although Congress has traditionally used oversight committees to keep the I.R.S. in check, in protecting the tax law from I.R.S. abuse, these traditional oversight techniques would prove suboptimal. Congress cannot directly oversee the I.R.S., which explains why it has established oversight boards. But although the Taxpayer Advocate and the I.R.S. Oversight Board are effective in their current duties, neither encapsulates exactly what is needed to protect the tax system from I.R.S. abuse. If Congress wanted to protect the tax system from I.R.S. abuse through formal oversight, it would need to create a new oversight body.

A. Congress Cannot Provide Effective Oversight

Congress could, of course, legislatively counter I.R.S. decisions with which it disagrees. But it "cannot (and should not) engage in detailed oversight of the entire operation of the Service."[162] Congress does not have the time or expertise to review every decision that the I.R.S. makes. In 2010 alone, the I.R.S. issued approximately 1,874 private letter rulings.[163] And private letter rulings only represent a small portion of the I.R.S.'s activities during the year. Requiring Congress to become aware of each position the I.R.S. takes and to change the law every time it disagrees with the I.R.S.'s administration or interpretation is an unattractive position to take.[164]

Moreover, it assumes that Congress has the ability to act as an effective overseer. Congress's track record, however, belies its effectiveness.

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fail to meet deadlines. Mary Jo Heston, *The United States Trustee: The Missing Link of Bankruptcy Crime Prosecutions*, 6 AM. BANKR. INST. L. REV. 359, 383 (1998). Unlike the Office of the Taxpayer Advocate or the Internal Revenue Service Oversight Board, the U.S. Trustee can intervene in litigation in cases where such intervention would help protect the bankruptcy system. In re A-1 Trash Pickup, Inc., 802 F.2d 774, 776 (4th Cir. 1986).

162. Stephanie Hoffer, *Hobgoblins of Little Minds No More: Justice Requires an IRS Duty of Consistency*, 2006 UTAH L. REV. 317, 330 (2006).

163. The number of private letter rulings comes from searching (advanced: "private letter ruling" & "IRS PLR" & DA (aft 12-31-2009 & bef 01-01-2011)) on WestlawNext.

164. In fact, a number of congressional representatives have weighed in on the commodities mutual fund private letter rulings, almost universally criticizing the I.R.S. for the rulings. *See* Jeremiah Coder, *Top Tax Officials Grilled on Mutual Fund Commodity Investments*, 134 TAX NOTES 524, 524 (2012) (Senators Carl Levin and Tom Coburn "sent a letter to the IRS urging it to permanently extend its moratorium and to 'reevaluate the tax treatment of all mutual funds currently allowed to treat indirect commodity investments as income derived from "securities" under section 851.'"). But Congress itself has not acted to correct the I.R.S.'s course.

Congress has, for example, repeatedly found itself unable to pass timely tax legislation that is broadly seen as both necessary and important. In 2008, and again in 2012, it has had difficulties passing an alternative minimum tax patch, in spite of the fact that failure to pass such a patch would increase the tax bills of millions of middle-class Americans.[165]

In fact, some Senators have noticed — and objected to — the I.R.S.'s position on commodities mutual funds. In December of 2011, two Senators sent a letter to the I.R.S. requesting that it extend its moratorium on issuing commodity mutual fund private letter rulings.[166] In January 2012, the Senate's Permanent Subcommittee on Investigations held a hearing on the I.R.S.'s issuance of commodity fund private letter rulings.[167] But outside of letters and hearings, Congress has done nothing that would require the I.R.S. to enforcing the tax law. With no reason to believe Congress will change to become a better overseer, using Congress to provide oversight will not serve to protect the tax system.

B. *The Office of the Taxpayer Advocate Does Not Have the Resources to Protect the Tax System*

In many ways, the Office of the Taxpayer Advocate provides an excellent model for how to police the I.R.S. Unlike congressional representatives, I.R.S. employees have the time and expertise to focus

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165. *See, e.g.*, Jeffrey H. Birnbaum, *Patch Approved for Alternative Minimum Tax; Early Filers to Wait for Refunds As IRS Applies Fix to Computers*, WASH. POST, Dec. 20, 2007, at D01 ("Congress gave final approval yesterday to a bill that would protect about 20 million households from a tax increase caused by the alternative minimum tax, but the legislation passed so late in the year that 15 million Americans will probably have to wait longer than usual to get their refunds in 2008."); William Hoffman, *Olson Predicts Up to 3 Filing Seasons in Wake of Fiscal Cliff*, 137 TAX NOTES 1162, 1162 (2012); Wesley Elmore, *Failure to Pass AMT Patch Would Be Disastrous, Potter Says*, 137 TAX NOTES 859, 859 (2012) ("Failing to pass an alternative minimum tax patch during the lame-duck session of Congress would be a 'real recipe for disaster' resulting in delayed processing of tax returns and economic harm, a former IRS official said November 14.").

166. Jeremiah Coder, *Top Tax Officials Grilled on Mutual Fund Commodity Investments*, 134 TAX NOTES 524, 524 (2012). The I.R.S. had temporarily stopped issuing the rulings, not because it believed they were wrong, but because it was exploring whether it should issue broader guidance on which taxpayers in general could rely. *Id.*

167. *Compliance with Tax Limits on Mutual Fund Commodity Speculation: Hearing Before the Permanent Subcomm. on Investigations of the Senate Comm. on Homeland Security and Governmental Affairs*, 112th Cong. 5 (2012) ("By issuing the private letter rulings that it has issued in the mutual fund area, the IRS is undermining its own longstanding efforts to go after sham corporations and transactions that are used to avoid paying a tax.").

specifically on issues of tax administration. Moreover, I.R.S. employees would not face the major issues (besides standing) that would impede third parties from challenging the I.R.S.'s placing form over substance. Because the I.R.S. does not manage mutual funds, employees in a watchdog office could not decide to pursue their own private letter ruling rather than challenging the I.R.S.'s promulgation of such rulings. In addition, they would not face the costs of litigating such a case, with no hope of monetary relief.

Moreover, placing enforcement in an office in the I.R.S. would present certain advantages over either Congressional or third-party enforcement. If taxpayers challenged the I.R.S. every time it recognized a taxpayer's compliance with formal requirements that had no substance, administering the tax law could become unwieldy and overly-expensive. The convenience and efficiency of permitting taxpayers to, for example, make entity elections for tax purposes would dissolve, and, in spite of their complexity, the previous facts-and-circumstances test may become a more efficient process. An office in the I.R.S., on the other hand, could develop the expertise necessary to differentiate between permissible and impermissible situations for permitting purely formal actions.[168]

An office within the I.R.S. charged with challenging the I.R.S.'s administration of the tax law would, of course, face significant problems, especially the inside-outside problem and the dissonance of challenging the organization of which it is part.[169] The history of the Office of the Taxpayer Advocate demonstrates that these problems are real and significant. But the current success of the Taxpayer Advocate demonstrates that they are not insuperable. The office must, however, be designed carefully to take into account both the conflicts and the appearance of conflicts.

Although the Office of the Taxpayer Advocate provides a model for creating a watchdog within the I.R.S., the Taxpayer Advocate, as it currently stands, cannot function as that watchdog for a number of reasons. The Office of the Taxpayer Advocate is charged with improving taxpayers' experience in dealing with the I.R.S.; the National Taxpayer Advocate not only needs to have experience with the tax law, but she must have "a background in customer service."[170] Preventing the I.R.S. from recognizing substance-free transactions does nothing to improve an individual taxpayer's interaction with the I.R.S. It maintains the integrity of the tax law, which provides a collective benefit to taxpayers, but the Office of the Taxpayer Advocate was created to provide individual, not collective, benefit.

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168. For the group to be able to differentiate permissible and impermissible formal primacy, it necessarily must be composed of individuals with significant knowledge of the tax law and practice. *See infra* Section V.B.

169. *See supra* note 152 and accompanying text.

170. I.R.C. § 7803(c)(1)(B)(iii)(I).

Moreover, the Office of the Taxpayer Advocate would lack the ability to enforce its decisions even if it took on the proposed watchdog role. Currently, the Office of the Taxpayer Advocate essentially does two things: it helps taxpayers resolve their problems with the I.R.S., and it makes an annual report to Congress detailing areas in which taxpayers and the I.R.S. clash and proposing administrative and legislative changes that would ameliorate these clashes.[171] The Office of the Taxpayer Advocate cannot, however, sue the I.R.S. to halt the problems or enforce its proposed solutions.[172] And the limitations on the Office of the Taxpayer Advocate's litigation are not limited to its inability to engage counsel. The Taxpayer Advocate cannot file *amicus curiae* briefs that relate to taxpayer rights.[173] Moreover, although the Taxpayer Advocate can comment on proposed rules and regulations promulgated by the I.R.S., the I.R.S. has no obligation to consider the Taxpayer Advocate's comments.[174]

In light of its limited recourse, any success the Taxpayer Advocate enjoys is a testament to its persuasive abilities. And while the Taxpayer Advocate has successfully pursued its mission, its success probably relies at least in part on the fact that the taxpayers it supports provide a sympathetic picture to other taxpayers. The I.R.S. knows that mistreating taxpayers can lead to a popular backlash, and potentially to legislation such as the two Taxpayer Bills of Rights. The problems of the tax system at large, however, are more metaphysical than personal, and are thus less sympathetic. Without a sympathetic taxpayer to provide the threat of backlash, the Taxpayer Advocate would have less leverage to encourage change.

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171. *Id.* § 7803(c)(2)(A).

172. *See, e.g.*, 28 U.S.C. § 516 ("Except as otherwise authorized by law, the conduct of litigation in which the United States, an agency, or officer thereof is a party, or is interested, and securing evidence therefor, is reserved to officers of the Department of Justice, under the direction of the Attorney General."); 5 U.S.C. § 3106 ("Except as otherwise authorized by law, the head of an Executive department or military department may not employ an attorney or counsel for the conduct of litigation in which the United States, an agency, or employee thereof is a party, or is interested, or for the securing of evidence therefor, but shall refer the matter to the Department of Justice."). Congress has authorized the Chief Counsel of the I.R.S. to represent the Secretary of the Treasury Department, but only in the Tax Court. I.R.C. § 7452. But this authorization does not extend to the Taxpayer Advocate's being represented by non-Department of Justice counsel.

173. NATIONAL TAXPAYER ADVOCATE, 2011 ANNUAL REPORT TO CONGRESS 573 (2012), http://www.irs.gov/pub/irs-utl/irs_tas_arc_2011_vol_1.pdf.

174. *Id.* at 573–74.

Even if the Office of the Taxpayer Advocate could find a way to reconcile a mission to protect the integrity of the tax system with its current mission to protect taxpayers and could effectively do so in light of its constraints on litigation, this watchdog duty should not be imported into the Office of the Taxpayer Advocate. Currently, Congress underfunds the I.R.S.[175] As it currently stands, the Taxpayer Advocate lacks the resources to deal with its increasing workload without sacrificing quality and timeliness.[176] Adding an additional mandate to an Office of the Taxpayer Advocate already stretched thin would force the Taxpayer Advocate either to further cut their services to taxpayers in need or to limit its watchdog work.

C. *The Internal Revenue Service Oversight Board Is Not Constituted to Protect the Tax System*

In terms of its composition and its mission, the Oversight Board seems like the ideal outside group to police the I.R.S. and protect the tax system. Its members have the expertise both in tax law and its administration that allows the Oversight Board to understand the I.R.S.'s actions in light of the Code. The majority of the Oversight Board consists of individuals who are not employed by the I.R.S., and therefore do not face the inside-outside tensions that could bedevil an oversight board located within the I.R.S. Moreover, the Oversight Board has the time and resources to oversee the I.R.S.'s issuance of private letter rulings and other administrative actions. Although the Oversight Board is only obligated to meet quarterly,[177] it can engage the staff necessary to fulfill its duties.[178]

Still, as currently constituted, the Oversight Board cannot meet the responsibilities necessary to protect the tax system. Congress specifically carved out of the Oversight Board's purview the authority to "direct tax policy or administration."[179] These carve outs exist because Congress intended that the Oversight Board play a governance, not a management, role within the I.R.S.[180] And, in fact, the Oversight Board functions more like an advisory board than any type of governing board.[181]

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175. *Id.* at vi ("And despite a huge expansion in the IRS's workload, Congress has reduced the IRS's funding in each of the last two years.").

176. *Id.* at 693.

177. I.R.C. § 7802(f)(2).

178. *Id.* § 7802(e)(3)(A).

179. Eric A. Lustig, *IRS, Inc.—The IRS Oversight Board—Effective Reform or Just Politics? Some Early Thoughts from a Corporate Law Perspective*, 42 DUQ. L. REV. 725, 739 (2004) [hereinafter Lustig, *IRS Oversight*].

180. NAT'L COMM., RESTRUCTURING, *supra* note 156, at 14.

181. Lustig, *IRS Oversight*, *supra* note, at 768.

D. *If We Want an Oversight Board, Congress Could Form a New One*

Although a new oversight board would add complexity and require additional resources, it is the oversight method with which Congress appears most familiar, at least in the tax context. As such, even though it is a second-best solution at best, Congress may prefer it to a new and unfamiliar oversight method. If Congress created a new oversight board, though, it would have to design a new oversight office carefully, taking the parts of the current oversight entities that work and altering the parts that do not. A new oversight office, properly designed, could go a long way toward protecting the tax system from I.R.S. abuse.

1. *The Mandate*

Any new oversight board should have authority to review and comment upon proposed regulations. While the Treasury Department has broad authority to enact regulations,[182] in some circumstances, those regulations can harm the tax system.[183] In many cases, the oversight board would not be the only one commenting on regulations; the Administrative Procedure Act of 1946 ("APA")[184] generally requires a notice-and-comment process for proposed regulations.[185] It accepts interpretive regulations from the notice-and-comment requirement, however.[186] And, although the I.R.S. generally solicits comments when it proposes a regulation, it maintains that most of its regulations qualify as interpretive regulations, and are thus technically exempt from the notice-and-comment requirement.[187]

Moreover, even if all regulations were subject to notice-and-comment procedures, the oversight board would be tasked with a different goal than others who comment. Presumably, interested taxpayers will comment on how the proposed regulations will affect their business. The Office of the Taxpayer Advocate will highlight the way a proposed regulation will affect taxpayers in their interaction with the I.R.S. But neither is expressly looking at how the proposed regulation affects the tax system as a whole. Moreover, to the extent the proposed regulation is taxpayer-favorable, neither has an incentive to oppose a regulation that violates established tax

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182. I.R.C. § 7805(a) ("[T]he Secretary shall prescribe all needful rules and regulations for the enforcement of this title.").

183. *See supra* note 39 and accompanying text.

184. Pub. L. No. 79-404, 60 Stat. 237 (codified as amended in scattered sections of 5 U.S.C.).

185. 5 U.S.C. § 553(b)-(c).

186. *Id.* § 553(b).

187. Matthew H. Friedman, *Reviving* National Muffler*: Analyzing the Effect of* Mayo Foundation *on Judicial Deference as Applied to General Authority Tax Guidance*, 107 NW. U. L. REV. COLLOQUY 115, 122 (2012).

law. But this would be the oversight board's express purpose: to make sure the regulation does not harm the tax system, especially by violating the tax law as it currently stands.

The authority to simply comment on proposed regulations would be insufficient. The Office of the Taxpayer Advocate is currently pressing for a requirement that the I.R.S. actually consider its comments.[188] But it is possible that other taxpayers, out of their own self-interest, will echo the Taxpayer Advocate's view on how the proposed regulation will affect taxpayers' interaction with the I.R.S. Because the new oversight board would be the only group commenting from the perspective of protecting the tax system, it is even more important that Congress require the I.R.S. to consider its recommendations.

The ability to review and comment on proposed regulations would, standing alone, do very little to protect the tax system. Regulations generally already face notice-and-comment, and interested parties have the ability to object to proposed regulations that veer too far afield of their statutory basis. But, as the I.R.S.'s treatment of commodities mutual funds demonstrates, the I.R.S. can also use other rulings, not subject to notice-and-comment, in a way that damages the tax system.[189] The oversight board charged with protecting the tax system would need the authority to review the I.R.S.'s less-formal rulings, as well, and should also have the authority to look at other I.R.S. actions.[190]

2. *The Composition*

For the oversight board to protect the tax system, members would have to have a deep knowledge and understanding of the tax system, while also having some degree of independence from the I.R.S. The Office of the Taxpayer Advocate, for example, ensures the appropriate familiarity with the tax law by appointing to its head a person with significant experience in the tax law.[191]

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188. *See supra* note 174 and accompanying text.

189. *See supra* Section III.C.

190. The oversight board would not have the resources to look at everything that the I.R.S. does, of course. Rather, it would have to prioritize its reviews. Its method of prioritization should include both stricter scrutiny of areas that have had problems in the past and a random assortment of unproblematic areas. *See infra* note 198 and accompanying text.

191. Prior to her appointment, Nina Olson, the current National Taxpayer Advocate, worked in private practice representing taxpayers in tax litigation. She also owned a tax planning and preparation firm, and chaired the American Bar Association Section of Taxation's Low Income Taxpayers Committee. National Taxpayer Advocate Bio, http://www.taxpayeradvocate.irs.gov/Media-Resources/National-Taxpayer-Advocate-Bio.

It would be essential that the members of the oversight board have significant knowledge of and familiarity with the tax law. For example, they would need the ability to differentiate between respecting form at the expense of substance (*e.g.*, permitting mutual funds to invest in commodity-linked notes) and respecting form because determining the underlying substance is unimportant or administratively infeasible (*e.g.*, entity election).[192]

In addition to the knowledge base members must have, members of the oversight board would need to both be and appear impartial. Some of the I.R.S. actions they challenge would likely favor the government, while others would favor taxpayers. To prevent the board from tilting toward or against the government's interests, the board should be split between government employees and individuals working in the private sector.

The members who worked for the government would ideally be selected from the I.R.S., the Treasury Department, or another governmental agency that worked extensively with the tax system. Such individuals would potentially face pressure to act in ways that favored the I.R.S., but such pressure could be counterbalanced by implementing procedures shielding them. In creating the National Taxpayer Advocate, Congress demonstrated that it could provide such shielding.

Moreover, the board members employed in private industry would provide a counterbalance to an overly-government-favorable approach. And from where would the oversight board draw these private industry members? Many tax professional organizations include, in their mission statements, the promotion of an equitable tax system. For example, the American Bar Association's Section of Taxation works to provide "leadership to support the development of an equitable, efficient and workable tax system."[193] The Tax Section of the New York State Bar Association works to further "the public interest in a fair and equitable tax system."[194] Ensuring that the I.R.S.'s actions do not harm the tax system fits comfortably with these missions.

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192. *See* 61 Fed. Reg. 21,989, 21,990 (May 13, 1996) ("Treasury and the IRS believe that it is appropriate to replace the increasingly formalistic [entity determination] rules under the current regulations with a much simpler approach that generally is elective.").

193. ABA Section of Taxation, *About Us*, http://www.americanbar.org/groups/taxation/about_us.html.

194 . New York State Bar Association, *New York State Bar Association Tax Section Purpose*, http://www.nysba.org/AM/Template.cfm?Section=Mission_Statement4.

3. The Method

Recently, Congress has shown no interest in properly funding the I.R.S.[195] Given its antipathy toward funding the I.R.S., there is no reason to believe that Congress will provide significant funding to oversee the I.R.S., especially where such oversight does not obviously protect a particular constituency. As a result, the oversight board will not have the resources to review every I.R.S. action to make sure it does no harm to the tax system.

Even with sufficient funding, however, an oversight model that required the overseer to look at every I.R.S. action would be undesirable. It would significantly impact the I.R.S.'s efficiency, and, because the I.R.S. follows the tax law in most cases, such oversight would be unnecessarily broad. Instead, the oversight board would need to audit the I.R.S.'s actions.

Some of its audits should be reactive, based on flags raised by, among other things, the I.R.S.'s past behavior. Various flags for this type of reactive oversight could include, among other things, the I.R.S.'s attempting to promulgate rulings or regulations in response to judicial losses. And once a category of ruling or an I.R.S. office that promulgates problematic rulings has been flagged as an issue, the oversight board could look more closely at that category or that office.

The reactive model is backward-looking, however, and does not entirely solve the problem of the I.R.S. harming the tax system. As long as it only looks at areas that have had problems in the past, it will be unable to prevent novel problems that arise. To capture those problems, in addition to its reactive audits, the oversight board should engage in random audits.

In selecting taxpayers to audit, the I.R.S. largely depends on statistical profiling to ensure that it focuses its scarce resources auditing taxpayers who are likely to owe more than they paid.[196] However, it also selects a small number of taxpayers to audit randomly.[197] These random audits serve a different purpose than its statistical choices: with these random audits, the I.R.S. can gather information about the effectiveness of its enforcement, the size of the tax gap, and other information that will help improve its statistical choices.[198] Similarly, the oversight board would need to choose at random some I.R.S. actions. Doing so would allow it to find

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195. *See, e.g.*, William Hoffman, *Panelists Acknowledge IRS Challenges, Consider Funding*, 135 TAX NOTES 44, 44 (2012) ("The IRS faces myriad challenges posed by the global economy and new mandates from Congress, but its biggest test will be finding the funding that will enable it to meet its increasing workload . . . .").

196. Sarah B. Lawsky, *Fairly Random: On Compensating Audited Taxpayers*, 41 CONN. L. REV. 161, 165 (2008).

197. *Id.* at 166.

198. *Id.*

new problems that fire-alarm oversight would miss. It also would send a message to the I.R.S. that a department or individual may be subject to oversight, even with no red flags pointing in that direction.

4. *The Location*

The various models demonstrate that an oversight body can successfully be located within or without the I.R.S. itself. Congress located the Office of the Taxpayer Advocate within the I.R.S., but instituted firewalls to ensure its independence. Those firewalls included protections against the National Taxpayer Advocate using her office to advance her status and ability. They demonstrate, for example, that such oversight can occur from within the I.R.S. itself, if the office is properly designed and insulated from internal pressures. Alternatively, an outside group can be created and charged with oversight, if the group consists of competent individuals who are familiar with the tax law they are protecting.

While the oversight board could function in either place, locating it outside of the I.R.S. would be preferable or provide it with any other significant benefit. Being part of the I.R.S. would not guarantee that the I.R.S. would cooperate with the oversight board.[199] Congress would have to take extra care to insulate the board from I.R.S. pressure. And, although the federal government can technically end up on opposite sides of a lawsuit, that door is rarely opened.[200]

An oversight board not housed within the agency it seeks to oversee does not face the same potential pressures. It has more ability to act independently, even without Congressional protection. And, although Congress would have to specifically give it standing and authority to bring cases to court, it would not require permitting the I.R.S. to sue itself. As a result, even though the oversight board could be located within the I.R.S., creating it separately from the I.R.S. makes practical and administrative sense.

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199. *See, e.g.*, Heather B. Conoboy, Note, *A Wrong Step in the Right Direction: The National Taxpayer Advocate and the 1998 IRS Restructuring and Reform Act*, 41 WM. & MARY L. REV. 1401, 1416 (2000) ("releasing negative statistics about IRS abuses could, if opposed by the IRS, result in a lack of cooperation between the main collection agency and the Office of the NTA.").

200. Michael Herz, *United States v. United States: When Can the Federal Government Sue Itself?*, 32 WM. & MARY L. REV. 893, 896–97 (1991) ("Because DOJ controls most agency litigation, it is able to keep numerous potential interagency suits from reaching the courts.").

V. FIRE ALARM OVERSIGHT

Although Congress could create a new oversight board to protect the tax system, that would not constitute the best form of oversight. Even though Congress is comfortable with delegating oversight of the I.R.S. to formal boards and offices, this type of direct oversight is flawed at best. Even a perfectly designed oversight board would face significant problems in protecting the tax system.

For one thing, having a dedicated oversight board would not necessarily ensure complete oversight. The board would not necessarily be aware of everything the I.R.S. did, and, with a finite number of people and a finite budget, could only look at some of what the I.R.S. does.[201]

That it cannot look at every decision does not, of course, disqualify an oversight board. Using an audit approach, where the oversight board examines a subset of the I.R.S.'s decisions, could prevent the I.R.S. from abusing the tax law.[202] Especially where the board chose its audit targets at random, a small number of audits could have a much larger effect on the I.R.S.'s compliance with the tax law.[203]

Potentially even more damaging to the effectiveness of a new oversight board is the fact that Congress has not shown any interest in properly funding the I.R.S.[204] And Congress underfunds the I.R.S. in spite of the fact that, historically, every additional dollar the I.R.S. has spent on enforcement programs has netted the federal government between $3 and $14 of additional revenue.[205]

But the oversight I propose would not necessarily raise revenue. In fact, in the three examples presented in this Article, successful oversight may have lowered federal revenues. If an oversight board had prevented the I.R.S. from imposing the telephone excise tax, it would have eliminated litigation costs, but it would have also prevented the I.R.S. from collecting taxes in the first place.

Even where the oversight would prevent the I.R.S. from creating a taxpayer-favorable rule, moreover, its actions would not necessarily increase federal revenue. If the I.R.S. made clear, for example, that it would not

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201. *See supra* Sections IV.B., C.

202. Mariano-Florentino Cuellar, *Auditing Executive Discretion*, 82 NOTRE DAME L. REV. 227, 252 (2006).

203. *Id.* at 255 ("Indeed, if regulators avoided random auditing techniques altogether, they would face at least two problems. Existing knowledge about where problems lie may prove deficient or outdated. Perhaps more important, strategic actors can simply evade review by avoiding domains where enforcement is already occurring.").

204. *See supra* note 175 and accompanying text.

205. *Budgeting to Fight Waste, Fraud and Abuse: Hearing Before the Comm. on the Budget H. of Rep.*, 110th Cong. 37 (2007).

countenance mutual funds investing, directly or indirectly, in financial instruments that reflected the value of commodities, the funds would not suddenly become taxable. Instead, they would change their investment strategy. Likewise with tax-exempt organizations: if they believed that they would become taxable, they would likely change their behavior to comply with the rule.[206]

A. Deputizing the Public

Mathew McCubbins and Thomas Schwartz have christened the type of oversight illustrated by the I.R.S. Oversight Board, and by the Office of the Taxpayer Advocate, "police-patrol oversight."[207] They define police-patrol oversight as "Congress examin[ing] a sample of executive-agency activities, with the aim of detecting and remedying any violations of legislative goals and, by its surveillance, discouraging such violations."[208] Police-patrol oversight requires active participation by Congress or its agent. Congress can hold hearings, can read documents or commission studies, but police-patrol oversight requires time and effort from Congress.[209] It also requires Congress to have the ability to find problems and realize that they are problems.

In contrast to police-patrol oversight, McCubbins and Schwartz discuss "fire-alarm oversight." Fire-alarm oversight is less centralized and less active than police-patrol oversight.[210] Instead of Congress or its agent examining administrative decisions and actions, "Congress establishes a system of rules, procedures, and informal practices that enable individual citizens and organized interest groups to examine administrative decision (sometimes in prospect), to charge executive agencies with violating congressional goals, and to seek remedies from agencies, courts, and Congress itself."[211]

Legislators generally like fire-alarm oversight.[212] Police-patrol oversight requires significant time and effort, much of which goes to

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206. There would undoubtedly be exceptions, of course. But those exceptions would be entities making a political statement, and would not produce any substantive stream of federal revenue.

207. Mathew D. McCubbins & Thomas Schwartz, *Congressional Oversight Overlooked: Police Patrols Versus Fire Alarms*, 28 AM. J. POL. SCI. 165, 166 (1984) [hereinafter McCubbins & Schwartz, *Congressional Oversight*].

208. *Id.*

209. *Id.*

210. *Id.*

211. *Id.*

212. Congress has used fire-alarm oversight broadly, for example, to enforce "[v]irtually all modern civil rights statutes . . . ." Pamela S. Karlan, *Disarming the Private Attorney General*, 2003 U. ILL. L. REV. 183, 186 (2003).

exploring acts that do not violate Congressional intent.[213] Even where Congress or an oversight board finds a problem, moreover, the violation may not harm any particular constituent and, as such, may not provide political benefits to the congressional representatives involved.[214] In fact, for the oversight this Article proposes, correcting the I.R.S. would rarely aid a particularized constituency. Though ending the I.R.S.'s abuse of the tax system helps taxpayers generally, the benefits are diffuse, and no legislator is likely to benefit politically from engaging in such oversight.

Fire-alarm oversight, then, provides legislators with significant benefits. They do not have to waste time tracking down abuses that will provide them with some political benefits. Instead, they can wait until constituents come to them with bad behavior, and then can attempt to remedy the problem and reap the political rewards.[215] But, for purposes of policing the I.R.S., properly-designed fire-alarm oversight may provide an even more important benefit to legislators: they can shirk the political costs of unpopular oversight.[216] Because fire-alarm oversight delegates at least some enforcement ability to third parties, legislators never need to get their hands dirty in the enforcement, instead permitting motivated third-parties to ensure that the I.R.S. enforces the law.[217]

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213. McCubbins & Schwartz, *Congressional Oversight*, *supra* note 207, at 168 ("[C]ongressmen engaged in police-patrol oversight inevitably spend time examining a great many executive-branch actions that do not violate legislative goals . . . .").

214. *Id.* ("They might also spend time detecting and remedying arguable violations that nonetheless harm no potential supporters. For this they receive scant credit from their potential supporters.").

215. *Id.* ("[U]nder a fire-alarm policy, a congressman does not address concrete violations unless potential supporters have complained about them, in which case he can receive credit for intervening.").

216. *Id.* ("A congressman's responsibility for [oversight] costs is sufficiently remote that he is not likely to be blamed for them by his potential supporters.").

217. Note that Congress's implementing fire-alarm oversight of the I.R.S. does not mean that it fully divests itself of its oversight responsibility and authority. Fire-alarm oversight versus police-patrol oversight is not a zero-sum game; rather, Congress "can choose either form or a combination of the two." *Id.* at 166–67. That is, Congress can delegate authority to third parties to watch the I.R.S., but can, nonetheless, step in (with hearings, changes in law, or any other type of police-patrol oversight) when it becomes aware of bad behavior either that third parties are unaware of or uninterested in, or when it would be to legislators' political benefit to become involved.

B. *Standing and Fire-Alarm Standing*

Standing remains a significant impediment to Congress's implementing fire-alarm oversight. Admittedly, when the I.R.S. misapplies the tax law in a manner beneficial to a specific taxpayer, other taxpayers suffer an injury.[218] But such small, indirect injuries have not, historically, provided standing for taxpayers to challenge I.R.S. actions.[219]

And, in fact, providing standing to third-party taxpayers may prove challenging for Congress. As a practical matter, a generalized ability to challenge I.R.S. discretion would create significant problems in the administration of the tax law. The diffuseness of the harm could allow any taxpayer to challenge any I.R.S. decision.[220] The government needs revenue, however, and the I.R.S. needs some amount of flexibility in interpreting and enforcing the tax law.[221] A constant and omnipresent threat of lawsuits at its every move would impede the I.R.S.'s ability to exercise this flexibility.[222]

The constitutionality of third-party taxpayer standing could pose an even more-significant impediment to fire-alarm standing. Courts have generally rejected taxpayer standing for failing to meet the "case or controversy" requirement of Article III of the Constitution.[223]

Congress has faced this case-or-controversy requirement previously. In the 1970s, Congress began to allow environmental citizen suits.[224] These citizen suits came in two versions: one empowered private individuals to sue private corporations that were violating environmental laws, while the other allowed private citizens to sue the government agency responsible for enforcing the environmental law, alleging that it has failed in its duties.[225]

By the late 1980s, hundreds of environmental citizen suits were pending in various courts.[226] But in 1992, with the Supreme Court's decision

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218. Matthew A. Melone, *A Leg to Stand On: Is There a Legal and Prudential Solution to the Problem of Taxpayer Standing in the Federal Tax Context?*, 9 PITT. TAX REV. 97, 140 (2012) [hereinafter Melone, *A Leg*] ("The victims reside on the circumference — all harmed in the same way.").

219. *See supra* notes 83–85 and accompanying text.

220. Melone, *A Leg*, *supra* note 218, at 146.

221. *See, e.g.*, Cass R. Sunstein, *Is Tobacco a Drug? Administrative Agencies as Common Law Courts*, 47 DUKE L.J. 1013, 1055–56 (1998) (stating that administrative agencies have flexibility to interpret ambiguous statutes).

222. Rachel E. Barkow, *Insulating Agencies: Avoiding Capture Through Institutional Design*, 89 TEX. L. REV. 15, 22 (2010) ("All else being equal, agencies would prefer not to become mired in legal challenges . . . .").

223. *See generally* Melone, *A Leg*, *supra* note 218, at 132–34.

224. Frank B. Cross, *Rethinking Environmental Citizen Suits*, 8 TEMP. ENVTL. L. & TECH. J. 55, 55 (1989).

225. *Id.*

226. *Id.* at 55–56.

in *Lujan v. Defenders of Wildlife*,[227] citizen suits became significantly more difficult.[228] In *Lujan*, the Supreme Court held that citizens who brought a citizen suit under the Endangered Species Act lacked standing to bring an action.[229] The Court held that a plaintiff could not maintain standing if she "claim[ed] only harm to [her] and every citizen's interest in proper application of the Constitution and laws, and seeking relief that no more directly and tangibly benefits him than it does the public at large. . . ."[230]

If a direct statutory grant of standing in the environmental area is insufficient to provide third parties with Article III standing, it seems unlikely that such a grant of standing would work in the tax area. Moreover, Congress's ability to overcome this deficiency statutorily is not clear. Though the Supreme Court has never categorically stated that Congress cannot create an expansive standing in some circumstances,[231] even an explicit statutory grant of standing may not be sufficient to overcome the Article III case-or-controversy rule.[232]

In spite of the necessity of direct and tangible harm and benefit for Article III standing, though, Congress may be able to design a review procedure that permits third parties who face no tangible harm to nonetheless litigate on behalf of the tax law. Rather than federal district courts, though, Congress could require that such suits be brought in the Tax Court.

Congress established the Tax Court under Article I of the Constitution.[233] Because "standing is formally an Article III doctrine that does not constrain legislative courts and similar non-Article III tribunals," it

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227. 504 U.S. 555 (1992).

228. Will Reisinger, Trent A. Dougherty, & Nolan Moser, *Environmental Enforcement and the Limits of Cooperative Federalism: Will Courts Allow Citizen Suits to Pick Up the Slack?*, 20 DUKE ENVTL. L. & POL'Y F. 1, 34 (2010).

229. *Lujan*, 504 U.S. at 578.

230. *Id.* at 573–74.

231. Michael E. Solimine, *Congress, Separation of Powers, and Standing*, 59 CASE W. RES. L. REV. 1023, 1049 (2009) ("Supreme Court doctrine on the scope of congressional power to influence standing in federal court is not a model of clarity. No Justice has suggested that Congress lacks any power in this regard, and . . . Congress may statutorily bless injuries to provide standing where those injuries would not have been recognized at common law. But beyond those generalities, the level of congressional authority to authorize departures from the private rights model is not clear.").

232. David Krinsky, *How to Sue Without Standing: The Constitutionality of Citizen Suits in Non-Article III Tribunals*, 57 CASE W. RES. L. REV. 301, 304 (2007) [hereinafter Krinsky, *How to Sue*].

233. I.R.C. § 7441 ("There is hereby established, under article I of the Constitution of the United States, a court of record to be known as the United States Tax Court.").

should be possible for Congress to permit the Tax Court to hear "non-cases."[234]

Of course, the fact that the Article III standing requirement does not apply to the Tax Court does not mean that Congress has an unfettered ability to assign jurisdiction to the Tax Court.[235] Although the Supreme Court has not established "formalistic and unbending rules" to determine when Congress can authorize non-Article III tribunals to have jurisdiction, it has laid out factors that are essential to the judicial power, over which non-Article III tribunals cannot have jurisdiction.[236] For example, non-Article III tribunals cannot exercise broad jurisdiction; instead, they must deal with a "particularized area of law."[237] Suits claiming private rights fall within the core of matters reserved for Article III courts.[238] On the other hand, Congress can use non-Article III tribunals to resolve questions about which they possess "obvious expertise."[239]

Granting jurisdiction to the Tax Court over fire-alarm oversight suits should fit within the bounds the Supreme Court has established to grant standing in non-Article III tribunals. Congress would not add a broad grant of jurisdiction to the Tax Court. Instead, it would receive jurisdiction to hear claims from uninjured taxpayers that the I.R.S. blatantly violated the tax law, to the detriment of the tax system.

Moreover, the claims would not attempt to validate a private right of the plaintiff. Protecting the tax system is a public, not a private, right.[240] In addition, because there is no case or controversy, Article III courts could not exercise jurisdiction over the case. As such, permitting these fire-alarm oversight cases would not remove from Article III courts cases that belong there.

Finally, the Tax Court has specific expertise in the area of tax law. Even though the contours of Congress's authority to vest jurisdiction in Article I courts remain unclear, its ability to grant the Tax Court jurisdiction

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234. Krinsky, *How to Sue*, *supra* note 232, at 308.

235. *See, e.g.*, Thomas v. Union Carbide Argricultural Products Co., 473 U.S. 568, 584 (1985) ("Congress may not vest in a non-Article III court the power to adjudicate, render final judgment, and issue binding orders in a traditional contract action arising under state law, without consent of the litigants, and subject only to ordinary appellate review.").

236. Commodity Futures Trading Commissioner v. Schor, 478 U.S. 833, 851 (1986).

237. *Id.* at 852.

238. *Id.* at 853.

239. *Id.* at 855–86.

240. *Cf.* N. Pipeline Constr. Co. v. Marathon Pipe Line Co., 458 U.S. 50, 69 (1982) ("[A] matter of public rights must at a minimum arise 'between the government and others.'").

over these fire-alarm oversight cases seems to fit comfortably within the scope established by the Supreme Court.

C. *Prudential Considerations*

Empowering third parties to sue the I.R.S. creates several practical problems. From the I.R.S.'s perspective, the unfettered ability of taxpayers to sue about matters with which they have no involvement potentially creates an avalanche of lawsuits, absorbing I.R.S. time and money, and distracting from its administrative and tax-collection duties. Moreover, this additional burden would not redound solely on the I.R.S. The specter of third-party challenges could raise the cost, both in money and in time, of receiving a ruling.

Moreover, because the ruling could not be challenged until after it became public, it would reduce the taxpayer's certainty in relying on the ruling. But private letter rulings improve the efficiency of administering and of complying with the tax law, especially in areas where the law is unclear as applied to a particular transaction. Such a broad grant of standing would significantly reduce the efficiency of administering the tax law, and could impede taxpayers from engaging in beneficial, but new, transactions.

Of course, this added expense assumes that non-party taxpayers do challenge the I.R.S. In many cases, third parties would have at best little incentive to challenge a private letter ruling. A competitor to the taxpayer may want to remove from the taxpayer a potential advantage. But to the extent that a transaction favoring substance provides a competitive advantage, the competitor may gain more by imitating the strategy and obtaining its own private letter ruling than by challenging the existing private letter ruling. If, on the other hand, the competitor did not believe the strategy provided any advantages to the taxpayer, the competitor could allow the taxpayer to keep pursuing the strategy.

Non-competitor third parties would have even less incentive to challenge private letter rulings. Because they do not compete with the taxpayers who receive the ruling, they would gain no competitive advantage by preventing the taxpayers from pursuing the strategy. In order to launch the challenge, though, these third parties would need to expend the time to review private letter rulings and the money to launch a challenge. In the end, though, they would receive no upside from the termination of a bad strategy.[241]

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241. In fact, when the tax law tries to enlist other taxpayers to assist the I.R.S. in its enforcement, it recognizes the incentive problem. As a result, for example, whistleblowers who disclose tax evasion by others are entitled to between 15 and 30 percent of the proceeds collected as a result of her information. I.R.C. § 7623(b)(1).

If Congress grants third parties standing to challenge I.R.S. actions, it must circumscribe that standing to prevent such suits from paralyzing the I.R.S. In addition, it must create incentives for third parties to become involved. This Section will provide a blueprint for how an effective grant of third-party standing could be designed.

1. *Third-Party Challenges to the I.R.S.*

Although Congress should be able to create jurisdiction for the Tax Court to hear these challenges, it should not permit taxpayers to initially raise their claims at the Tax Court level. Instead, it should mandate that any challenge by a third party to an I.R.S. action must first be raised at the I.R.S. level. Such a rule would provide symmetry with taxpayers suing on their own behalf: a taxpayer cannot file a suit against the I.R.S. for a refund until the taxpayer has exhausted her administrative remedies.[242]

If the I.R.S. finds against the taxpayer, though, she should have the ability to appeal the I.R.S.'s determination to the Tax Court. If the Tax Court ruled against the taxpayer, its determination would be final. Because Congress would authorize these fire-alarm oversight cases without a case or controversy, taxpayers would lack standing to appeal an adverse ruling to an Article III court.[243]

Requiring administrative review before a taxpayer can go to court slows the process and raises the costs to the taxpayer of challenging I.R.S. practice. By raising the costs, both financially and temporally, the extra layer of review should diminish the number of suits faced by the I.R.S. In addition to this indirect additional expense, though, taxpayers who file these suits should face a refundable upfront cost.

2. *Impediments to a Landslide of Litigation*

Taxpayer standing, which provides standing based on the more general harm inflicted on all taxpayers by the I.R.S.'s incorrect action, raises the possibility of a flood of litigation.[244] Though history suggests that such a

242. I.R.C. § 7422(a).

243. Arizonans for Official English v. Arizona, 520 U.S. 43, 64 (1997) ("The standing Article III requires must be met by persons seeking appellate review, just as it must be met by persons appearing in courts of first instance."). If, on the other hand, the I.R.S. lost at the Tax Court level, it would probably have standing to appeal. *See* Krinsky, *How to Sue*, *supra* note 232, at 313–14. Although this asymmetry may appear unfair, the fact that the taxpayers haven't suffered a cognizable harm, and that the I.R.S. should have some discretion in how it administers the tax law, helps ameliorate the unfairness.

244. *See, e.g.*, D.C. Common Cause v. D.C., 858 F.2d 1, 6 (D.C. Cir. 1988) ("*Frothingham*'s bar on federal taxpayer standing derived from concerns both about

flood would not follow the expansion of taxpayer standing,[245] any such flood would wreak havoc on the I.R.S.'s ability to administer that tax law and collect revenue. To prevent a potential flood of litigation from disrupting the I.R.S., Congress must include some roadblocks to taxpayers' broad ability to challenge the I.R.S.

One simple way to limit the quantity of fire-alarm oversight suits is to not publicize the possibility. The Internal Revenue Code is a long and complex law,[246] filled with specialized provisions that do not impact most Americans, provisions about which most Americans are unaware.[247] Though the complexity of the tax law exacts costs on taxpayers, both in the financial and time commitments necessary to comply with the law,[248] here, obscurity could serve a gatekeeping purpose. If only motivated taxpayers with knowledge of the tax law know about the grant of broad taxpayer standing, only such relatively sophisticated taxpayers will file suits.

In addition to not publicizing the availability of fire-alarm oversight, Congress should raise the cost of filing meritless suits. If a potential litigant knows that filing a suit will potentially cost her money unless her suit is meritorious, she will presumably think twice before filing the suit.

Taxpayers already must pay a fee to access certain services provided by I.R.S. For example, the I.R.S. charges a fee to taxpayers who request a private letter ruling. In 2013, that fee is $18,000.[249] If a third-party taxpayer's ability to challenge I.R.S. actions were predicated on first paying an $18,000

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the attenuation of the federal taxpayer's interest in federal expenditures and about the flood of litigation that would otherwise result."); Pub. Citizen, Inc. v. Simon, 539 F.2d 211, 218 (D.C. Cir. 1976) ("What was wrought by the *Flast* opinion in opening the door to taxpayer actions, yet opening it only part way was pragmatic in result, avoiding the flood of all manner of taxpayer actions.").

245. *See, e.g.*, Kenneth Culp Davis, *Standing: Taxpayers and Others*, 35 U. CHI. L. REV. 601, 634 (1968) ("Supreme Court law from 1899 to 1923 allowed federal taxpayers to challenge federal disbursements, with no resulting flood of litigation . . . .").

246. In 2000, the Code contained approximately 1.4 million words, while the Treasury regulations added another 8 million words. Michael J. Graetz, *100 Million Unnecessary Returns: A Fresh Start for the U.S. Tax System*, 112 YALE L.J. 261, 273–74 (2002). In addition, in 2000, the I.R.S. published thousands of pieces of administrative guidance. *Id.* at 274.

247. *See* United States v. Second Nat'l Bank of N. Miami, 502 F.2d 535, 549 (5th Cir. 1974) ("This case has required us to explore one of the lesser known chambers in a labyrinthine Internal Revenue Code honeycombed with obscure passageways.").

248. JOEL SLEMROD & JON BAKIJA, TAXING OURSELVES: A CITIZEN'S GUIDE TO THE DEBATE OVER TAXES 160 (4th ed. 2008) ("[The I.R.S.'s administrative costs in enforcing the Code are] dwarfed by the costs borne directly by taxpayers, known as *compliance costs*.").

249. Rev. Proc. 2013-1, 2013-1 I.R.B. 1, 68.

fee, even assuming the fee would be refunded if the taxpayer won, taxpayers would face a serious impediment to suing. Only taxpayers with sufficient resources would be able to sue, and they would only do so if they believed their case meritorious.

Limiting the pool of potential litigants is in line with the goals of this Article. There are a number of groups, across the political spectrum, that are interested in the proper administration of the tax law, including Tax Analysts,[250] Americans for Tax Reform,[251] the Tax Policy Center,[252] and the Tax Foundation.[253] Ideally, groups such as these, with knowledge of and interest in the tax law, should pursue I.R.S. abuse of the tax system in this fire-alarm oversight regime. Charging a fee would be a rough method of ensuring that only such highly-motivated organizations became involved.

A fee to challenge the I.R.S. is significantly problematic, however. While the government can charge fees, even where the service provided redounds to the benefit of the public at large, those who pay the fees must receive "a special benefit, above and beyond that which accrues to the public at large. . . ."[254] It is not clear what special benefit, over and above an improved tax system, a third-party challenger would receive.

Rather than imposing a fee, then, perhaps it would make more sense to impose a fine on a taxpayer-challenger who loses the challenge. The Code allows the Tax Court to impose a penalty of up to $25,000 on taxpayers who maintain proceedings primarily for delay, who advance frivolous claims, or who have failed to pursue available administrative remedies.[255] The tax law could similarly provide for penalties where a third-party's challenge of the I.R.S. was not reasonably likely to succeed.[256] Though the risk of penalty provides a less-direct deterrent to frivolous actions than an upfront fee

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250. Tax Analysts "was established to defend the public interest in a policy arena shot through with private influence." *Tax Analysts*, HISTORY OF TAX ANALYSTS, http://wwwtaxanalysts.com/www/website.nsf/Web/HistoryOfTax Analysts?OpenDocument (last visited May 29, 2013).

251. Americans for Tax Reform lobbies for a "system in which taxes are simpler, flatter, more visible, and lower than they are today." *Americans for Tax Reform*, ABOUT AMERICANS FOR TAX REFORM, http://www.atr.org/about.

252. The Tax Policy Center "provides timely, accessible analysis and facts about tax policy to policymakers, journalists, citizens, and researchers." *Tax Policy Center*, ABOUT US, http://www.taxpolicycenter.org/aboutus/index.cfm.

253. The Tax Foundation is a non-partisan think tank that advocates "for simple, sensible tax policy at the federal, state, and local levels." *Tax Foundation*, ABOUT US, http://taxfoundation.org/about-us.

254. Ayuda, Inc. v. Attorney Gen., 848 F.2d 1297, 1301 (D.C. Cir. 1988).

255. I.R.C. § 6673(a)(1).

256. And, in fact, it would make sense for an additional penalty to apply if the taxpayer loses at the I.R.S. appeals level and then appeals to the Tax Court, where it loses again.

would, the risk of paying a significant penalty should cause potential litigants to think carefully before filing their complaints. And a penalty for frivolous suits seems fairer than a fee to access the adjudicative system.

3. *Incentives to Sue*

While Congress needs to place some impediments in the way of third-party taxpayers suing the I.R.S., ultimately, the purpose behind providing broad taxpayer standing is to permit third-party taxpayers to effectively police the I.R.S. As a result, Congress must also include inducements to taxpayer suits.

The traditional inducements do not exist in the context of third parties protecting the tax system. Taxpayers generally sue the I.R.S. because they believe they have paid more taxes than they owed, and they want the court to order the I.R.S. to refund the excess taxes. Third-party litigants, on the other hand, have not overpaid their taxes, and, upon winning, will not receive damages. As a result, such third-party litigants would bear the whole cost of policing the I.R.S. without any benefit other than improving tax administration.

To the extent they have the budget, some of the groups mentioned previously[257] may be willing to bear such costs. Tax Analysts, for example, has pursued Freedom of Information Act requests against the I.R.S. to get access to, among other things, private letter rulings, and against the Department of Justice to gain access to records of federal district court opinions.[258]

Still, even though some groups may be willing to act, at their own expense, solely to improve the tax system, these non-party litigants perform a service for taxpayers in general. As a result, if they had to bear to full cost of litigating with the I.R.S., they would be less likely to litigate and, as a result, creating third-party standing would still leave taxpayers with insufficient oversight.

To rectify the potential under-enforcement, then, along with third-party standing, Congress should provide that a successful third-party litigant receives an award of reasonable attorney's fees. Though U.S. litigants generally bear their own costs, victorious or not,[259] hundreds of statutes provide for awarding attorney's fees to "plaintiffs who successfully sue to

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257. *See supra* notes 250–253 and accompanying text.

258. Mark A. Segal, *Tax Data Disclosure Under the Freedom of Information Act: Evolution, Issues and Analysis*, 9 AKRON TAX J. 79, 82–83 (1992).

259. Mark S. Stein, *The English Rule with Client-to-Lawyer Risk Shifting: A Speculative Appraisal*, 71 CHI.-KENT L. REV. 603, 603 (1995) [hereinafter Stein, *English Rule*] ("In America, parties to civil litigation generally bear their own attorney fees.").

enforce the statutes."[260] This type of "[o]ne-way fee shifting can help Congress monitor the activities of the executive branch [and] deter continued agency misconduct . . . ."[261]

By providing reasonable attorney's fees for a successful litigant, Congress diminishes the cost to that litigant of overseeing the I.R.S. Reducing this cost is essential if Congress wants this type of oversight to work. From an economic perspective, a plaintiff decides whether or not to sue based on three factors: the amount of money she will receive if successful, the probability of her being successful, and the costs of bringing the suit.[262] To the extent that the amount of money multiplied by the probability of success exceed her costs, bringing the suit has an expected value. But because the third-party litigants who will bring these suits have not suffered any direct loss, they have no expected return, even with a 100 percent certainty of winning; they will, on the other hand, face costs associated with appealing to the I.R.S. and to the Tax Court. As a result, from an economic perspective, brining such a suit makes no sense.

The various tax think tanks and watchdog groups mentioned above may still have some non-economic interest in the proper administration of the tax law. Even if they do, though, they face real litigation costs, which may discourage them from providing the optimal amount of fire-alarm oversight. If, however, they can recoup their costs in a successful suit, their expected loss grows closer to zero, providing more incentive to act. Providing this type of fee-shifting should generally encourage watchdog groups to litigate in cases where they believe they will win, while the proposed penalty for frivolous suits should discourage litigation where they have less faith in their chances.[263]

An unsuccessful plaintiff would not, of course, receive an award of attorney's fees. And this would mitigate another potential problem with fire-alarm enforcement: its impingement on the I.R.S.'s administrative discretion. The I.R.S. has finite resources, and needs discretion in determining which tax laws to vigorously enforce; courts generally will not "quarrel with an agency's rational allocation of its administrative resources."[264]

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260. Bruce L. Hay, *Fee Awards and Optimal Deterrence*, 71 CHI-KENT L. REV. 505, 505 (1995).

261. Harold J. Krent, *Explaining One-Way Fee Shifting*, 79 VA. L. REV. 2039, 2045–46 (1993) [hereinafter Krent, *Explaining*].

262. Henry N. Butler & Jason S. Johnston, *Reforming State Consumer Protection Liability: An Economic Approach*, 2010 COLUM. BUS. L. REV. 1, 94 (2010).

263. Stein, *English Rule*, *supra* note 259, at 604 ("The English rule, more than the American rule, tends to encourage a risk-neutral party to pursue litigation about which it is optimistic and tends to discourage such a party from pursuing litigation about which it is pessimistic.").

264. Haverly v. United States, 513 F.2d 224, 227 (7th Cir. 1975).

But allowing third parties to challenge the manner in which the I.R.S. enforces or refuses to enforce the tax law does not necessarily impinge on this important discretion. In the first instance, if challenged, the I.R.S. can explain why it chose to act as it did. The I.R.S. appeals office or the Tax Court can determine that it made an acceptable choice.

Moreover, the economics of such a third-party suit discourage all but the most meritorious challenges. If the plaintiff to a fire-alarm oversight case loses — even if her challenge was not frivolous — she does not receive an award of attorney's fees. As such, her challenge has cost her money. Without attorney's fees, her expected recovery is negative. As a result, she should be unwilling to bring a borderline case, and the I.R.S. should generally have the ability to maintain its administrative discretion.

Of course, providing for attorney's fees to a successful fire-alarm oversight plaintiff has its own problems. Awarding attorney's fees would, at the margins, provide the I.R.S. with incentive to decide meritorious cases against plaintiffs (because the initial challenge must be brought to the I.R.S. itself) and to appeal deserved losses to the Tax Court. The incentive for making wrong decisions arises because, if the plaintiff loses, the I.R.S. does not pay attorney's fees. On the margins, then, an award of attorney's fees encourages I.R.S. intransigence, increasing the amount of litigation.[265]

And awarding attorney's fees distorts more than just the I.R.S.'s decisions. Knowing the I.R.S. will pay a party's fees increases litigation costs, often in socially-unproductive ways.[266] Attorneys who reasonably expect to win will get paid more if they do more work, and their clients, who will not bear the expense of the additional fees, have no incentive to control their attorneys' costs. And because the award of attorney's fees changes the plaintiff's expected gain and the government's expected loss, it reduces the incentive for either party to settle.[267]

The I.R.S.'s incentive to incorrectly find against the plaintiff and to unnecessarily and unwisely appeal may be overstated. As a government agency, the I.R.S. does not fully internalize the cost of paying attorney's fees.[268] Moreover, to the extent the I.R.S. does internalize the cost, either financially or in terms of loss of pride or prestige, its evaluation of the cost of further litigation should still prevent it from unnecessarily extending litigation. Further appeals mean the plaintiff will incur additional costs, costs that the Tax Court will award to the plaintiff if successful. Thus, if the

265. Krent, *Explaining*, *supra* note 261, at 2081.

266. *Id.* at 2081.

267. *Id.* at 2080.

268. *Id.* at 2075. For the same reason, providing a victorious litigant with an award of attorney's fees should not lead to overdeterrence. *Id.*

plaintiff has a decent shot of winning on appeal, the I.R.S. should factor those future costs into its analysis of whether to proceed or not.[269]

To combat the incentives the watchdog groups' attorneys face to pad their hours, judges need some discretion in how they calculate attorney's fees. And generally, in federal cases, judges have that discretion. Broadly speaking, federal courts calculate attorney's fees using the lodestar method, in which the attorney receives an amount determined by multiplying a reasonable number of hours by a reasonable billing hourly billing rate.[270] To the extent that the judge finds the number of hours or the billing rate unreasonable, she can adjust those in the calculation.

Providing for judicial discretion reduces certainty and increases the judge's workload, but seems unavoidable. Different cases will require different expertise and different amounts of work; setting a bright-line cap on the billing rate or the number of hours that will be allowed in calculating attorney's fees would discourage watchdog groups from pursuing complex I.R.S. misconduct, and would lead to underenforcement. Moreover, if attorneys know in advance that their fee award may be reduced, they will have incentives to do necessary work, but not to pad the amount that they bill.

Provided the law takes into account the distortions in the parties' incentives, though, awarding attorney's fees to victorious plaintiffs will provide some incentive for watchdog groups to police the I.R.S. Attorney's fees permit the fire-alarm oversight to function, constraining the I.R.S.'s actions without overburdening it.

VI. CONCLUSION

In general, the I.R.S. does an effective job administering the tax system. It manages to process tax returns and refunds, find and prevent fraud, and otherwise make the tax system function, and does so with relatively few major problems.[271] Moreover, it manages to provide the high level of

269. If these general considerations prove insufficient for deterring I.R.S. intransigence, Congress could increase the amount of attorney's fees by a multiplier in cases where, for example, the Tax Court found the I.R.S. Appeals Office's decision insupportable, or found the I.R.S.'s appeal frivolous.

270. *See* Matthew D. Klaiber, *A Uniform Fee-Setting System for Calculating Court-Awarded Attorneys' Fees: Combining Ex Ante Rates with a Multifactor Lodestar Method and a Performance-Based Mathematical Model*, 66 MD. L. REV. 228, 236 (2006).

271. *See generally* TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION: THE MAJORITY OF INDIVIDUAL TAX RETURNS WERE PROCESSED TIMELY, BUT NOT ALL TAX CREDITS WERE PROCESSED CORRECTLY DURING THE 2012 FILING SEASON (Sep. 26, 2012), http://www.treasury.cov/tigta/auditreports/2012reports/201240119fr.pdf.

customer service that Congress intended in enacting the various Taxpayer Bills of Rights.[272]

In spite of its effectiveness at guarding against taxpayers' abuse of the tax system and its ability to treat taxpayers well, though, the I.R.S. has the unique ability to abuse the tax system itself. And, in many circumstances, it faces almost no constraints on its ability to do so. Sometimes it violates long-standing tax principles to confer a benefit on specific taxpayers, and nobody has standing to challenge the benefit. At other times, it can apply the tax law incorrectly in a manner that hurts taxpayers, but where the benefit to the individual taxpayers does not justify the expense of challenging its interpretation.

Either way, no current method exists of preventing the I.R.S. from abusing the tax system. No currently constituted oversight board exists with this charge, and no distinct constituency exists to hold the I.R.S.'s feet to the fire.

To protect the U.S. tax system, then, Congress needs to provide for such oversight. Although it could use its current fallback method, delegating authority to an oversight board, oversight boards have finite capability, especially where Congress seems unwilling to increase I.R.S. budgets. Better, then, would be to provide a system that permits — and even encourages — third parties interested in the efficient administration of the tax law to challenge the I.R.S. when it attempts to abuse the tax system.

Allowing this type of fire-alarm oversight broadens the scope of oversight while reducing its costs. Fire-alarm oversight has proven an effective regulatory tool. Interested taxpayers and taxpayer watchdogs will have the ability to act for the tax law itself, ensuring that the I.R.S. acts as an agent of Congress and, thus, ensure the continued integrity of the U.S. tax system.

272. *Id.* at 9–11.

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REFORMING THE CHARITABLE CONTRIBUTION SUBSTANTIATION RULES

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